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Walter Taplin Prize

The British Accounting Association and Accounting and Business Research offer a prize of £100 for the best article published in each annual volume. The prize is named in honour of the Journal's founding editor, the late Walter Taplin. The prize relating to Volume 22 (1991/92) was awarded to M. Buchan, K. V. Peasnell and R. A. Yaansah for their paper 'Netting off Assets and Liabilities' in the Summer 1992 issue.

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Issues in Corporate Accountability and Governance: An Editorial

Kevin Keasey and Mike Wright*

Introduction

Corporate governance concerns the structures and processes associated with production, decision-making, control and so on within an organisation. Accountability, which is a sub-set of governance, involves the monitoring, evaluation and control of organisational agents to ensure that they behave in the interests of shareholders and other stakeholders. Problems pertaining to corporate governance go back at least as far as the separation of ownership from control within business organisations. Indeed, the difficulties associated with stewardship (entrusting an agent with the management of another's assets) and the *ex post* evaluation of stewardship (auditing) are clearly illustrated in Homer's *Odyssey* where the governance problems that arose in managing Odysseus' estate during his long absence could have been 'predicted' by agency theorists. More widely, there are also long-standing issues of conflicts between directors and stakeholders (Cannon, 1992). In terms of the more recent past, the framework of corporate governance within the UK, and generally within the Anglo-American model, which relies heavily on self-regulation and market-based sanctions, has been seen as suffering from a number of weaknesses which render accountability more problematic. In particular, there have been concerns over: the spread of creative accounting; the spectacular increases in unexpected business failures; the apparent ease of unscrupulous directors in expropriating other stakeholders' funds (for example, see Stiles and Taylor, 1993, in respect of the Maxwell affair); the very limited role of auditors; the apparently weak link between executive compensation and company performance; and the roles played by the market for corporate control and of institutional investors in generating excessively short term perspectives to the detriment of general economic performance. These concerns have brought corporate accountability and governance to the top of the policy agenda and highlight the importance of both stewardship and efficiency in the debate. The report of the Cadbury Committee (1992) has been one response to these issues.

The proposals of the Cadbury Committee rely largely upon improved information to shareholders, continued self-regulation and a strengthening of auditor independence. The Committee's terms of reference encompass these financial aspects of governance and hence address issues that directly affect the accountancy profession. The report is structured around seven headings: Codes of Best Practice; Directors' Service Contracts; Audit Committees; Interim Reporting; Enhancing the Perceived Objectivity of the Audit (rotation of audit partners and reporting of non audit fees); Enhancing the Effectiveness of the Audit (statements of internal financial control and the business as a going concern); and Endorsement of Audit Work by Others. In respect of the emphasis of the Cadbury Report on the Board, the proposals were as follows: there should be a remuneration committee (made up of non-executives) which determines executives' pay; directors should not be appointed for more than three years without shareholders' approval; the roles of chairman and chief executive officer should be separated; the emoluments of the chairman and highest paid UK director should be disclosed; and the computation of performance related pay fully explained. The content of this Special Issue of *Accounting and Business Research* shows that, although the Cadbury Committee report has much to commend it, there are a number of dimensions of corporate accountability and governance that have not been addressed. In particular, consideration is needed of alternative means of regulating companies which involve stakeholders being more active in monitoring managers.

This Special Issue brings together a variety of academic perspectives on corporate governance and accountability. The papers have been selected on the basis of the usual refereeing procedures of this journal. The purpose of this editors' introduction is threefold: to provide an overview of the main issues; to indicate the contributions of the

*The authors are, respectively, professor of finance and accounting in the University of Leeds and professor of financial studies in the University of Nottingham. They thank Rob Watson, Noel O'Sullivan and Steve Thompson for comments on an earlier draft.

papers; and to discuss corporate governance with an emphasis on the developments that are taking place within the Anglo-American systems of corporate governance and internal control.

Definition and framework

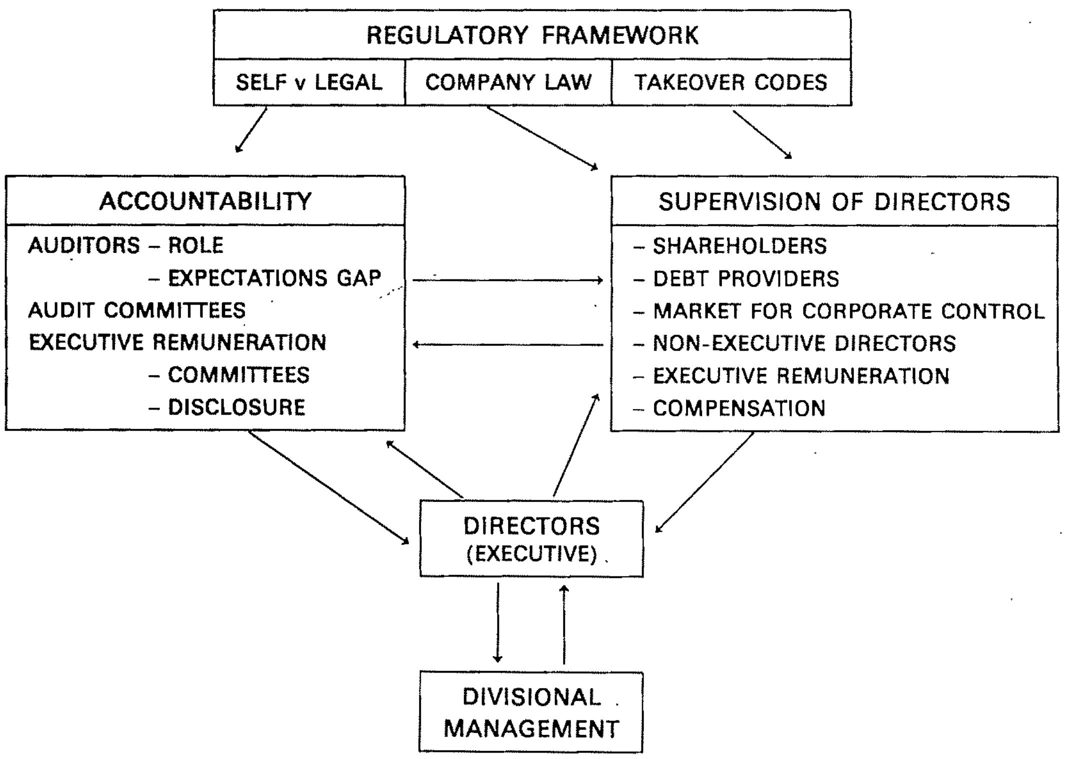
The need for the complex organisations we call firms and for some form of regulation, that is a framework of corporate governance, may be viewed as arising from the costs and problems associated with contracting. Since the work of Coase (1937) it has been clear that contracting costs give rise to the need for institutional structures to deal with them. This insight provides the basis for the explanation of the existence of firms (and the boundaries thereof) and of accounting. Some would even go so far as to argue that:

> in an unregulated economy, the institutional structure that we observe is contracting-cost efficient. Contracting costs do exist and institutional form is economically relevant. Decades, centuries and even millennia of competitive innovation in institutional forms leads to the more efficient contracting technology tending to replace the less efficient. (Ball and Smith, 1992, p. 2)

Unfortunately, while such an approach usefully underlines the relevance of institutional frameworks when contracting costs are present, it plays down the problems involved in writing contracts *ex ante* and ensuring compliance *ex post*. Moreover, it has been argued by Chambers (1993) that any existing situation will limit the contracts which are considered permissible and that a more fruitful approach is to view the firm as a temporary and unstable coalition of participants. Similarly, it is also becoming clear that appropriate governance structures are historically and politically contingent (Roe, 1991). It is the presence of these issues which gives rise to the fundamental debate about the nature of corporate governance and accountability.

Given the above, it is not surprising that there is considerable debate about what constitutes corporate governance. For the purposes of the present paper, corporate governance will be considered as shown in Figure 1. The two key elements of governance concern supervising or monitoring management performance and ensuring accountability of management to shareholders and other stakeholders (Tricker, 1984). These aspects of governance and accountability are closely interrelated and introduce both efficiency and stewardship dimensions to corporate governance. To date, the emphasis has been primarily on stewardship issues—for example, the misappropriation of funds

Figure 1
Corporate Governance Framework



by non-owner managers. Equally important, however, is the issue of how the structure of governance motivates those in control to increase the wealth of the business. Good corporate governance is as much concerned with correctly motivating managerial behaviour towards improving the business as with directly controlling the behaviour of managers. Executive remuneration, especially if it involves increasing the ownership stake of directors, may be one means of motivating good behaviour. However, considerable problems arise in devising appropriate remuneration contracts that are in the best interests of shareholders. A further aspect of accountability is, therefore, to monitor and disclose such issues.

The need for the supervision and accountability of directors arises because of the so-called divorce between ownership and control in large enterprises with diffuse ownership. Supervision may take various forms ranging from systems where shareholders are 'outsiders' with little direct incentive to monitor management and where emphasis is placed on the role of the takeover mechanism to discipline underperforming managers, to systems where shareholders are 'insiders' with very close involvement in the management of the enterprise. Issues concerning the appropriate supervisory system also extend below the top tier to the problems of dealing with divisional managers.

Third parties have a key role to play in ensuring the accountability of directors and management, especially auditors and non-executive directors. This in turn raises the question of what their roles are expected to be and the difficulties in carrying them out. The existence of a gap between what auditors are legally required to do and what they are expected to do by society in general is one manifestation of the problem. Nonetheless, it has to be noted that the supervision and accountability aspects of corporate governance take place within a wider regulatory framework which regulates relationships with external third party contractors, and this forms the third major part of the present framework and includes elements of self-regulation and statutory rules.

A further, but not much discussed, dimension of the corporate governance debate are the wider ethical and societal concerns (for example, see Salbu, 1993; Keeley and Graham, 1991) which have attracted increasing interest during the early 1990s. Gallhofer and Haslam (this issue) argue that the notions of accounting to the public at large and of concern that accounts be mobilised for purposes other than the strictly economic can be traced in the work of Jeremy Bentham. Macdonald and Beattie (this issue) observe that a particular UK problem is that the elements of corporate governance have been developed piecemeal, so that these interrelationships have not been fully considered nor integrated.

Supervision of directors

The issue of the supervision of management arises because of conflicts of interest and asymmetries of information between managers and owners. With such asymmetries internal governance can be portrayed as trying to ensure the accountability of managers to their shareholders and other stakeholders while giving incentives to managers to make the most of profitable opportunities. Although this type of argument can be seen as underpinning a number of areas of study, it is at its starkest in the principal-agent literature (Fama and Jensen, 1983b; Jensen and Meckling, 1976).

The boundaries of an organisation reflect the limits of control over its own activities. Although both firms and markets can be seen as a nexus of contracts, organisations involve more than simple external trades, in that, they include internal norms, processes and relationships. In spite of the fact that mainstream principal-agent theory tends to ignore these issues, it is a useful lens through which to view governance problems (Bartlett, 1989; Armstrong, 1991). The major task of management is to coordinate diverse activities and motivate staff so that the goals of the organisation are achieved, although in practice goals may not be readily definable.

The above characterises organisations and markets as being separate entities. Of course, with recent developments, for example the closely tied sub-contractor, any separation is essentially arbitrary at the margin. Nonetheless, the existence of both markets and organisations raises the question of why some activities take place within one form rather than the other (Coase, 1937). One answer is that certain types of transaction are easier to govern through one means rather than another. Transactions can vary in the specificity of the underlying assets, duration, frequency, diversity, uncertainty/complexity, connectedness to other transactions, difficulty of performance measurement, etc. These factors help to explain how it is to be organised. Care needs to be taken, however, not to impart too much rationality into the very human processes of production and trade. The transactions we now see are often the result of relationships with a long history. These relationships may rise from inertia resulting from satisfactory results in the past. Also, both firms and markets are not static so that relationships today may be very different from ones in the past. Moreover, the general impact of legal and institutional forms on organisations should not be underestimated. Once it is accepted that organisations exist because of the nature of certain types of transaction and that organisations are directed (no matter how loosely) by some set of goals, then any consideration of internal governance has to take account of the activities that have to be planned

and controlled. In terms of coordination, internal governance has to solve problems of synchronisation, assignment and innovation. The solutions which are adopted to deal with these issues also need to bear in mind the long term strategic consequences of a given organisational form and means of supply. All of the above can be achieved in different ways, and the structure of governance needs to fit the broad outline of the organisation given its strategic aspirations and the context of its environment.

In situations characterised by asymmetric private information and bounded rationality, agents may have to be given incentives to motivate them to achieve the 'goals' of the organisation since it cannot be assumed that a commonality of interests exists. The incentives have to overcome the potential for opportunistic behaviour and imperfect commitment. More particularly, issues of pre-contractual (adverse selection) and post-contractual (moral hazard) opportunism have to be dealt with. These issues will vary according to the type of organisation and the type of contract that is being considered. Large organisations may be able to deal partly with adverse selection as they are able to afford quite thorough screening mechanisms for hiring their senior personnel; this is rarely the case for the small firm. Similarly, difficulties over screening the quality of external supply may lead to an internalisation of the problem. The traditional western solution to this problem has been the vertical integration of the supply chain, whereas the Japanese have commonly used a web of cross holdings to ensure commitment of supply.

The most obvious means for dealing with moral hazard type problems is direct monitoring. This may work well for the small firm owner who directly observes activities on the shop floor but it may not be so appropriate for the shareholders of the large conglomerate. Even in the context of small firms, it is doubtful, with the exception of the banks, that many creditors are in a position to monitor their interests directly because of the lack of available information. In fact, it is the availability of information on others in similar situations that may act as a brake on post-contractual opportunism. Competitive markets for products and labour may also help to cap the problem, as may certain types of internal promotion and incentive schemes. Of course, one problem with these latter solutions is that the very personnel that are in need of 'control' may be in charge of the operation of the schemes (see the discussion of executive compensation schemes below). Gilson and Roe (1993) argue that one of the prime benefits of cross ownership in Japan is the control of opportunism:

> Too many efforts to understand the Japanese system have suffered from Berle-Means blinders. Hidden by the focus on main banks is the fact that one-third of the cross ownership is held by industrial companies. We hypothesize that cross ownership reduces the risk of opportunism when parties make large relational investments. (p. 905)

Top Tier Governance

The nature of the operation of corporate governance depends upon a number of factors—such as size, complexity and contextual issues. In small firms, owners and managers are usually one and the same and information is concentrated among a few individuals. Following Fama and Jensen (1983a), in such non-complex organisations where information is concentrated, it is efficient (i.e. there is minimisation of agency costs) to combine decision management and control within a few individuals (owner/managers) and to limit residual claims to these same decision makers. Thus governance reduces to the owner/managers directly controlling the activities of labour. Beyond the owner/managed small firm, governance is complicated by the possibility of goal conflicts between owners and managers. Fama and Jensen (1983b) argue that, where there is a separation of management from ownership in complex organisations, it is more efficient to separate decision control from decision management. In other words, the residual owners in the organisation should have the authority and ability to control the management.

The key issue then concerns how this process is organised, since it is naive to argue that one system is appropriate in all circumstances. The papers in this Special Issue by Macdonald and Beattie and by Whittington address the features of corporate governance in the UK and elsewhere, particularly in Germany and Japan. The persistence of such different systems indicates the importance of contingent factors in shaping a viable corporate governance structure. In the Anglo-American system of corporate governance, individual shareholders ('outsiders') generally have little incentive to exercise 'voice' concerning the firm's direction. With freely tradable shares, corporate governance relies heavily on the effect of shareholders selling their shares ('exit'). Institutional shareholders can avoid some of the transactions costs incurred by individuals in the mobilisation of opposition to a board's policies, giving rise to a somewhat higher 'voice' potential. However, institutions may be reluctant to express their 'voice' publicly, and with large blocks of shares 'exit' may be difficult except in small amounts (which may in turn raise the question of insider information). As a result, institutions may give voice in private to avoid market reaction and resort to collective voice through committees of institutional investors.

The use of exit as a form of control in the Anglo-American model relies heavily on the efficiency of the takeover threat and in the takeover mechanism

identifying and replacing poorly performing managers (Chiplin and Wright, 1987). However, there are several arguments which question whether such efficiency exists. First, unless the bidder acquires an initial toe-hold stake (Shleifer and Vishny, 1988), there may be a disincentive to bid because of free-riding by existing shareholders who hold out for the full gains from merger (Grossman and Hart, 1980). Second, it is often difficult to obtain sufficiently detailed information to make a bid at a realistic price, especially with respect to multi-market firms. Third, management have the potential to use defensive and entrenchment strategies to raise the cost of acquisitions (Shleifer and Vishny, 1989). Fourth, hostile takeovers tend to occur in waves, with question marks being raised as to their impact on corporate governance in periods (such as the early 1990s) when such activity or the threat of a hostile takeover is low. Finally, it is not readily apparent that mergers are solely driven by the objective of removing underperforming managers (Jensen, 1986; Roll, 1986). There is, however, some recent evidence of relatively high levels of executive dismissals after hostile takeover and of more active institutional investor intervention (Franks and Mayer, 1990; Jenkinson and Mayer, 1992). Furthermore, non-executive directors are a means of strengthening shareholder voice and have been accorded a considerable weight in the corporate governance debate. Whilst non-executive directors do have an important role to play there remain doubts as to their ability to exercise sufficient supervision over executive management, their independence and the availability of sufficient numbers of high calibre individuals to carry out the task.

In Germany and Japan, a large part of corporate governance is through control by 'insiders': for example, through the holdings of institutions such as banks and keiretsu who have little intention of exiting and who exercise significant voice within the firm through bank directors on supervisory boards and concentrated cross-shareholdings and interlocking directorships. As noted above, Gilson and Roe (1993) attach particular importance to cross-ownership by industrial companies and relational contracting in the Japanese system, arguing that they reduce the risk of opportunism when parties make large relational investments since managers face a coalition of shareholders if they act opportunistically. In addition, product market competition plays a key role in preventing the system from lapsing into a 'conspiracy of passivity' and provides the incentive to monitor. Possibly as a reflection of its relative rarity, cross-ownership has received very little attention in the UK literature (for an exception see Meadowcroft and Thompson, 1987). In both Germany and Japan, hostile takeovers are extremely rare (Franks and Mayer, 1990). Many of these governance links operate through sustained implicit contracts which ensure that decisions are made in the interests of all parties (Kester, 1992) and reinforce the continuity of control. Such arrangements obviate the need for hostile takeovers, whether or not legislation prevents them.

Macdonald and Beattie (this issue) express some doubt about the ability to apply models from elsewhere to the UK, not least because of cultural differences. This point highlights a general problem in transplanting governance systems wholesale, as the transformation of Central and Eastern Europe also illustrates (see Lipton and Sachs, 1990; Corbett and Mayer, 1991; Filatotchev, Buck and Wright, 1992). There are in any case serious practical and coordination problems in moving wholesale to an insider system of governance (Jenkinson and Mayer, 1992). Indeed, there are indications, from at least the experience of Japan, that the trend is very much in the opposite direction. There is also some concern that the downside of the Germanic and Japanese systems is that they may not adapt sufficiently to changing circumstances (see Marsh, 1990; Wright, Thompson and Wong, 1992; Gilson and Roe, 1993). Macdonald and Beattie do suggest that the dual board structures of the German system and the Japanese notion of having different auditors for different purposes (statutory auditors monitor both financial statements and whether directors have properly discharged their duty and accountant auditors focus on financial statements) are ideas which may have a contribution to make in the context of the UK. However, it may also be necessary to recognise that corporate governance regulation requires some consensus on the issues of which stakeholders' interests count and on how various groups view the firm, the answers to which may differ between countries. The Anglo-American framework is driven largely by a concern for shareholders' interests and hence the London Stock Exchange in the UK and the Securities and Exchange Commission in the US have played a dominant role. The German codetermination framework, on the other hand, gives recognition to worker interests, bank interests and *de facto* recognition to supplier interests. Some changes may be discerned in the US recently, with for example some states trying to limit hostile takeovers by restricting ownership rights, principally to preserve jobs in the corporations which are acquired.

The growth of corporate restructuring, notably management and leveraged buy-outs, in the US and UK has been seen by some as one means by which the governance structures of quoted firms in particular can be improved and some of the shortcomings of the market for corporate control overcome (Thompson, Wright and Robbie, 1992). The introduction of less than fully diversified active investors, managers with significant equity ownership, as well as the bonding effects arising from commitments to meet large debt repayments

(Jensen, 1989; Thompson and Wright, 1991) can all be seen as strengthening corporate governance. Leveraged acquisitions can force the paying out of free cash flow, increase the focus on the best use of assets and emphasise the search for the disposal of redundant or poorly fitting assets. To the extent that a buy-out may take the form of a hostile bid (for example, a buy-out by a Leveraged Buy-Out Association such as Kohlberg, Kravis and Roberts) or a hostile internal bid by divisional management, there is at least some enhanced pressure on existing board directors to perform. There is, however, some debate as to whether corporate restructuring of this kind is widely applicable (because of the demands for stable cash flow to meet debt repayments); detrimental to long term performance (because cash is used to service debt rather than purchase capital equipment); only another short term fad (because institutions want a return within a relatively short period); and necessary (because corporations can generate the benefits without having to undergo the serious conflicts of interest with existing stakeholders) (Rappaport, 1990; Amihud, 1989). However, the governance structures and processes in buy-outs may not be as inflexible as some would suggest. They have been shown to involve: a mix of mechanistic aspects to do with meeting interest payments; requirements to keep within debt covenants; institutional board representation; levels of managerial equity stakes contingent on performance; regular detailed reports; and processual issues involving meetings between funding institutions and management (Sahlman, 1990; Green and Berry, 1991; Wright *et al.*, 1993). These combined mechanisms produce considerable flexibility in the governance structure. Extensive evidence from the US and UK in particular, but also from the Netherlands and France, shows that buy-out structures generate significant performance improvements, at least in the short term (see Palepu, 1990 for a review of the US evidence and Wright *et al.*, 1992 for a review of other studies). Evidence that such gains are largely attributable to enhanced managerial incentives (see e.g. Thompson *et al.*, 1992), suggests the general issue that there may be significant benefits to be had from improving the link between executive pay and performance even in the absence of a buy-out (Gilson, 1993), which is addressed in the next section.

Although little long term evidence is as yet available, there is some indication that whilst some buy-outs revert to stock market listing (with widely held share ownership) or are sold to third parties in a very short period, the majority retain their buy-out structures for considerable periods (Kaplan, 1991; Wright *et al.*, 1993). Such a heterogeneous view of buy-outs is important since it indicates that a particular form of governance may only be appropriate at certain stages in the life-cycle of a company.

Executive Compensation

A further method of bringing the actions of managers (executives) into line with the objectives of the shareholders is to link their compensation to the performance of the organisation. Performance related pay is argued to align and reduce the direct need for monitoring. This, of course, assumes that the owners of the organisation are involved with the design of the reward system, and in recent times this rarely seems to have been the case. It is interesting to note that the majority (if not all) of the stock options in existence reward good outcomes but absolve management from poor performance. This concern is particularly heightened with recent events in both the US and the UK which have seen large increases in executive pay which have not been matched by corporate performance. It is also noteworthy that in Japan, for example, executive remuneration issues receive less attention because other governance mechanisms are more effective (Gilson, 1993).

In devising a scheme of compensation that correctly motivates the executives it is important to realise that the existing determination of executive compensation is a complex process. For example, although Finkelstein and Hambrick (1989) found the bonus part of managers' remuneration to be related to financial performance, they could find no relationship between base salary and performance. Furthermore, for those companies operating a share option scheme (see Forker, 1992) the link between shareholders and firm performance is complicated by the actions of fund managers.

In a neoclassical world of labour markets none of the above mentioned complications arise, with executives receiving remuneration equal to their marginal product. However, a large body of evidence suggests that education, experience and organisational performance may be important determinants of executive compensation. An additional complication is the degree to which the performance of a wider management team affects the performance of an individual executive. It also needs to be borne in mind that the compensation package an executive receives is often negotiated at the point of hiring and, therefore, reflects to varying degrees the influence of human, signalling and screening arguments. Indeed, as pointed out by Lazear and Rosen (1981), chief executive officer remuneration may be more a prize for being hired than a direct reflection of productivity. This conclusion is supported by the empirical evidence which suggests that executive compensation is only weakly related to performance and seems to be more determined by company size or growth (e.g. Jensen and Murphy, 1990) and that this problem has been exacerbated in the 1990s with high rewards in recession not being related to corporate performance (Gregg *et al.*, 1993).

The major issue which arises is thus: what mechanisms are available to constrain executive compensation and how effective are they? Forbes and Watson (this issue) review the literature concerning the determinants of executive remuneration and point out that the design and monitoring of executive remuneration schemes is costly and because of the lack of transparency in these processes it is unclear that performance related remuneration schemes are necessarily in shareholders' interests. Using US data relating to large companies, Mangell and Singh (this issue) show that institutional investors are able to limit the payment of unearned compensation to the CEO, but that the presence of significant equity owners (those owning at least a 5% stake) has no significant impact. They also show that longer tenure by the CEO leads to greater compensation but that a number of other factors, specifically the percentage of outside directors, the director retainer and the CEO's years of company service, do not have a significant impact on compensation. They conclude that institutional investors are enhancing the accountability of CEOs, but that boards would benefit from having more outside directors who are impartial rather than more outside directors *per se*.

Remuneration committees may be established specifically to set executive remuneration, in particular to tie it more closely to performance. Evidence in the paper by Main and Johnston (this issue), which is based on a study of 220 large listed companies of which 63 had remuneration committees, is that there is no discernible effect on the breakdown between pay in cash and in the form of stock options which could be attributed to the existence of a remuneration committee. Forbes and Watson conclude that if the Cadbury Committee proposals regarding the greater roles of non-executive directors and remuneration committees are to be fulfilled, then, echoing Mangell and Singh, a more fundamental reform of the process of nomination and appointment of non-executive directors is required. Otherwise, and because the UK system of corporate governance does not provide shareholders with incentives to exercise 'voice', the remuneration committee is likely to be little more than a legitimating device whereby senior executives continue to set their own pay without any increase in their accountability to shareholders.

Disclosure of executive remuneration is also a key element in achieving effective corporate governance. As Egginton, Forker and Grout (this issue) point out, disclosure requirements in the UK have not kept pace with recent innovations in share option schemes and do not meet recommendations of institutional shareholders. They show that present statutory disclosure requirements are less demanding when options are satisfied by the purchase of existing shares rather than subscription to new shares. They argue that the forms of rewards for directors should be more transparent and that this cannot be left to the doubtful pressures of best practice. They suggest that requirements could be satisfied with minor amendments to the Companies Act specifying a disclosure table similar to that for fixed assets which would give details of all rights of executives to acquire shares by whatever means and a charge in the profit and loss account of listed companies to show the net costs of satisfying the exercise of director and non-director options.

Much of this discussion, of course, has related to large quoted companies with diffuse shareholdings. A contrasting perspective is provided by an examination of executive remuneration in mutual companies. As mutuals are non-profit making organisations and are owned by their members, it is doubtful whether their managers will be subject to the same control mechanisms and performance criteria as firms which have profit objectives. Furthermore, mutuality also protects such organisations from takeover bids from outside the sector and thereby removes a source of external control. Nonetheless, this seeming lack of control is slightly counterbalanced by the ease with which the owners (customers) can liquidate their interest in the organisation. How much this is a constraint on the behaviour of mutuals' managers is open to doubt. One further source of control comes from regulation but it needs to be realised that this, at the most, forces managers to meet only minimal standards of performance. Thus, in general, managers in mutual firms seem to operate with a reasonable degree of freedom. The analysis of mutuals, therefore, allows the impact of performance related pay to be gauged within the context of a fairly uncluttered control environment.

Ingham and Thompson (this issue) explore the extent to which the relationship between performance and remuneration is affected by the state of competition, in the particular case of UK building societies. Their results show that the change in building society regulations did affect the remuneration of building society CEOs. When there was little external competition, compensation was not related to performance. However, when competition increased, increasing profits led to increased remuneration. The results thus suggest that internal mechanisms of governance may need to be bolstered by external pressures.

Finally, monitoring of executive remuneration may not be equally applicable across the range of organisations. First and foremost, it has little role to play in the case of small firms where owners and managers are often synonymous. In the case of large firms, there is the difficulty of tying the activities of the individual executive to the performance of the firm. There are both the intertwining of a set of activities and the leads and lags of activities to contend with. In addition, it is unclear who in the organisation, apart from the executives whom

one is trying to motivate, has the knowledge and authority to design and activate an appropriate set of compensation packages. A further difficulty arises when the objectives of the organisation cannot be defined in easily measurable terms. In the NHS, for example, it is difficult to imagine how one would structure a performance related compensation package which was not prone to severe moral hazard problems.

Internal Governance

Internal governance issues concern the ability of main board directors to supervise lower tier managers in the interests of shareholders. Issues of accountability are raised concerning the design of internal control systems which fully reflect events. In the context of the recent governance debate, such systems are necessary for the provision of information to ensure accountability. To the extent that problems occur, a second tier agency problem exists (Thompson, 1988). For smaller organisations this is less of an issue, but serious problems are raised in large complex organisations. Since the early 1920s, the multidivisional (M-form) structure has come to be seen as a solution to the increasing problems of opportunism and control loss encountered within a centralised structure (U-form) as firm size and diversity increased (Chandler, 1962; Williamson, 1986). Empirical studies suggest superior performance in M-form firms in the UK and US, but not in Germany or Japan (see Cable, 1988, for a review). However, it is also the case that a number of firms with sub-optimal or corrupted M-form structures persist with such structures for considerable periods.

Hence, it is important not only to be aware that the structure has to fit the activities of the organisation, the environment it finds itself in, and the objectives of the organisation, but also the impediments to achieving such a fit. Such issues relate not only to deep rooted codes of behaviour in organisations (Arrow, 1974; Jones, 1992), organisational complexities and the impossibility of writing complete employee contracts, but also to governance structures which provide insufficient incentives or pressures on management to make changes (Wright and Thompson, 1987). Just as a question arises concerning the link between directors' pay and performance, so a similar second level issue arises concerning the rewarding of divisional managers. As a result, the issue of internal governance does not simply concern the need to adopt optimal internal structures and processes but to question the boundaries of the organisation and to divest activities where such governance cannot be introduced to the degree which is deemed necessary to achieve the organisation's objectives. Divestment may be to another established organisation or to incumbent managers in a management buy-out and may or may not involve activities in which the former parent continues to trade (Wright and Thompson, 1993). Where trading continues, vertical quasi-integration permits organisations to retain formal independence but formal and informal mechanisms can be used to control the relationship. The specification of contracts to ensure the appropriate degree of incentive compatibility is problematic and it is not cost effective to design contracts to deal with every state of the world. Vertical quasi-integration can be seen as a mechanism, for example to allow manufacturers to control the activities of distributors, with contracts being reinforced by the ability of manufacturers in a less formal sense to exercise power over their distributors, especially where there is an asymmetry of dependence between the parties to a transaction (Diamantopoulos, 1987).

The notion of matching governance structure to activity can be extended to other types of organisation, such as the National Health Service (NHS) in the UK. In many ways the organisational structure of the health service, until very recent times, can be viewed as fitting Ouchi's (1980) 'clan' model of control. The clan can be portrayed as a means of governance by socialising each member so completely that individual and organisational goals become merged. According to Ouchi, clans are most appropriate where measurement is difficult and knowledge of the process is low. The past operation of the medical profession can be seen as reflecting the difficulties involved with measuring the quality of health activities. The paper by Lapsley in this issue argues that the portrayal of the NHS as a clan based system of control may be somewhat overdone. Instead the medical profession may best be seen as being controlled by finance officers operating 'financial management by stealth'—thus suggesting a dual form of governance within the NHS. The recent developments in the NHS can be seen as trying to strengthen control via financial management. Although it is a little early to draw firm conclusions, there is some evidence of a change in emphasis in the organisational culture of health with some prominence being placed upon the 'managerial' functions. This change can be seen as being supported by the introduction of budgetary responsibilities and accounting controls, but the major issue of the relationship between medical professionals and management looks to be unresolved.

If the current influence of 'managerialism' in the NHS is open to doubt, the introduction of market-like operations is not. There is little doubt that health care has been opened up to market forces with notions of competitive tendering and the purchaser/provider split. Lapsley criticises these changes as being inappropriate because of the high transactions costs involved. He cites the difficulties of contract specification in health and the scope for opportunistic behaviour on the part of general

practitioners (GPs), who are having to enter contracts where there is little information on outcome or quality of patient care. Similarly, there are some question marks over how far providers are likely to compete because of the existence of local monopolies of specialised services. It remains open to doubt whether the changes will lead to a better fit between activity and governance structures.

Promotion of accountability

The need to ensure that directors and management are accountable to shareholders (and other stakeholders) introduces the role of third parties.

The Role of Auditors

The credibility of financial information underpins any system of corporate governance. If external shareholders start to doubt that they are able to obtain through financial reports a reasonable picture of the state of the organisation then the contractual base of the market system may come under pressure. Considerable concern surrounds the role of auditors in ensuring that the financial information provided to meet the needs of such stakeholders is credible. Chandler *et al.* (1993) in analysing the period 1840–1940 show that the current debate over auditors' responsibility needs to be seen as the latest movement in a continuing and fluctuating theme. Both they and Humphrey *et al.* (this issue), point out that over a long period the profession has encountered great difficulty in reconciling public expectations with the practicalities of auditing and with their legal responsibilities. Problems arise because of a gap between what the various parties expect of auditors and what they are actually supposed to do. Humphrey *et al.* show that the critical components of the expectations gap concern the auditors' role in relation to fraud detection, the extent of auditors' responsibility to third parties, the nature of balance sheet valuations, the nature of auditor independence, and aspects of the conduct of audit work. They do, however, point out that there is little evidence that the gap is the consequence of a general bias against professions; nor do user groups hold unrealistic views of the extent of audit work.

The existence of an expectations gap may be attributed to a number of issues. The activities of organisations are many, varied and often complex. The language of accounting has mirrored this complexity by a general and vague language where the vocabulary is confusing to the uninitiated. The language of accounting has allowed the tasks of accounting and auditing to take on the aspect of a profession with all the concomitant benefits. However, one problem with this is that the non-professional expects the professionals to know and understand the activities they are dealing with. This often means a fairly definite response to what might be a complex situation. Herein lies one part of the expectations gap: what is achievable by a professional body?

The above problem has been accentuated by the professional bodies responding to past criticisms by prescribing financial reporting qualities and standards. These may have bolstered the claims of professionalism but at the same time they have led to 'standards' by which the professionalism of individuals can be judged. Thus, the very attempt to deal with criticism may have increased the potential for an expectations gap—the attempt to standardise what is essentially a complex and variable process. The natural response to this explanation of the expectations gap is to demand more education. This type of response fits well with the perspective that the auditor as an agent needs the freedom to act as a professional. Taken to its extreme, this view of auditing would argue that if the auditing profession is not doing its job then the market will respond by developing a more suitable form of 'quality control'. In other words, if the 'gap' was any form of a real impediment to business then another solution would be found. This response, of course, falters on the usual assumptions of market participants having the information, power and coordination abilities to deal with market failures.

A more critical view of the auditing profession is that it has adopted vagueness and ambiguity in its work to avoid assessment. This allows the auditor to maintain his/her position *vis-à-vis* the ownership and management of the organisation. From this perspective, audit failures are almost impossible to judge because the activities of accounting and auditing are so vaguely defined. Here the expectations gap is not so much a reflection of unachievable standards of auditing practice as of worries of non-achievement of reasonable audit practices. This is compounded by concerns over a lack of auditor independence, the auditors being appointed by the boards they are supposed to be reporting on and the auditors consulting for the very same clients they are auditing. Furthermore, the Caparo case indicated that auditors are only responsible to the company and the shareholders as a body. Hence another criticism of the existing reporting system is the inability of audit users to attach legal liability to auditors for negligently audited financial statements. Thus, in terms of their own concerns, all other stakeholders have little reason to put any faith in audited financial statements. This, of course, adds to the concerns which arise from auditors being economic agents in their own right, with their auditing practices (actions, effort and pricing) partly reflecting such a position.

There are a number of ways in which the audit profession might deal with present concerns. First, it is necessary to consider the role of accounts. The present situation which emphasises a decision

usefulness viewpoint of accounts might be seen as one explanation of the current concerns; through attempting to provide information for all parties, accounts fail to be of use to any one specific group. If this is indeed the case then one solution would be to move back to a narrower stewardship focus. An emphasis on the stewardship function of accounts might direct attention towards how issues of fraud, business health and internal accounting controls are to be evaluated and reported. In a sense, this incorporates the Humphrey *et al.* suggestion that the auditing role should include the detection of fraud.

A further issue concerns auditors' liability. O'Sullivan (this issue) suggests that problems in corporate governance arise from an apparent paradox between the economic and legal interpretations of the auditor's risk sharing role. It has frequently been argued that a solution to the 'auditing problem' is the expansion of auditors' liability to third parties. At face value this should have the natural consequence of more truthful financial reporting and more effective corporate governance. In fact, Humphrey *et al.* propose that the responsibilities of auditors should be broadened to include existing and potential creditors and potential shareholders. It has also been suggested that the law should be changed to recognise the role of management in the reporting process. However, as argued by O'Sullivan, the practical application of increased liability is not so straightforward, There is little doubt that the likelihood of performing error free audits is low, and the response of auditors to increased liability might be the adoption of risk avoidance strategies (especially in complex multinationals) rather than the improvement of audit quality. O'Sullivan notes, however, that the recent introduction of compulsory insurance by the auditing profession may serve as an effective alternative to increased liability. Insurers can penalise low quality auditors through higher premiums and they are, therefore, well placed to encourage better quality auditing.

Elsewhere, Humphrey *et al.* propose that a solution would be the:

> creation of an independent regulatory agency to oversee the appointment of fee determination and practices of auditors of large companies.... We think that a principal cause of the perceived lack of auditor independence is the weak structural position of the auditor. In order to enhance the independence of the audit function the appointment of auditors and their fee determination needs to be taken out of the hands of the individuals on whom auditors are reporting. (1992, p. vi)

Thus one of the changes they suggest is an attempt to increase the independence of the auditors from the individuals they are supposed to be reporting on. This is similar in essence to the proposal for audit committees to deal with the appointment of auditors and to play a major role in the provision of information. Given that this proposal has received a lot of attention and forms part of the Cadbury Committee proposals, we consider it separately in the next sub-section.

Audit Committees

Audit committees are essentially committees of the board comprising at least two non-executive directors with the primary brief of reviewing the financial statements and the findings of the external auditors. They can thus be seen as an attempt specifically to designate responsibility for accounting-related matters, to provide a non-confrontational reporting structure for insiders and to supervise relations with the external auditor in an independent manner. In general, they are seen as giving status to non-executive directors and thereby improving the audit process. As noted by Collier (this issue), the audit committee is not a new concept and in the US it has a long history with a large growth in the number of committees occurring between the late 1950s and early 1980s. In contrast, in the UK most have come into existence after 1980. Interestingly, Collier finds that 65% of the top 250 UK listed companies had voluntarily formed an audit committee at January 1991. Furthermore, he surveys evidence which suggests that audit committees are fairly homogeneous as regards their composition, procedures and functions across the US and the UK.

The Cadbury Committee suggests that all listed companies should establish audit committees within two years. Thus, in general, a number of sources have seen audit committees as a means of improving the process of audit. This raises questions about the factors expected to impact upon the effectiveness of audit committees and whether a mandatory requirement is likely uniformly to affect the business population. From an agency perspective the effectiveness of audit committees will be influenced by the factors believed to alter agency costs. For example, where there is a high level of director share ownership (agency cost of equity) and a low level of debt (agency cost of debt), then there is less likelihood of audit committees being effective. The research is primarily US based and it does not lead to a definitive conclusion, but, in general, the evidence points towards a degree of effectiveness, with diligence and knowledge being two important explanators.

In terms of trying to assess the potential impact of a mandatory requirement for audit committees upon the business population through an examination of the factors which explain which firms have already adopted audit committees, Collier suggests that: 'The research findings with respect to factors determining whether a company has an audit com-

mittee are contradictory'. Nonetheless, he shows that the major UK listed firms which have voluntarily formed an audit committee have lower director ownership (agency cost of equity), a higher level of gearing (agency costs of debt), more non-executive directors and an internal audit function. Thus Collier's results indicate that directors' share ownership and incentives are important factors in the formation of audit committees. Therefore, the mandatory imposition of audit committees will have a disproportionate impact (varying with levels of gearing and directors' share ownership) on major UK listed companies.

An alternative view of the move towards audit committees is one where organisations are seen as needing to be responsive to the wider expectations of society, particularly in the light of recent scandals. This wider institutional perspective suggests that audit committees might be a means not of more effective reporting but of avoiding scrutiny. Perhaps it is too early to reach any firm conclusions, but it seems unlikely that audit committees will make the situation any worse although they cannot be seen as the sole solution to the problem of governance. It is to the issue of regulation that we now turn.

The nature of regulation

The two principal issues under this heading concern whether or not there needs to be regulation of corporate accountability and governance and, if regulation is deemed to be necessary, what form it should take.

It can be argued that there is no need for regulation of accounting since individual parties have incentives to make their own contracts in order to facilitate monitoring (e.g. Watts and Zimmerman, 1986). Similarly, agents will favour external independent audits as providing a signal to principals of the quality of their services (Watts, 1977). However, problems of costly contracting and contract enforcement make this somewhat problematical since under such circumstances an unregulated market would not necessarily satisfy all needs for information disclosure (Taylor and Turley, 1985). Hence, Whittington (this issue) amongst others argues that there is a case for the regulation of both accounting (to devise the necessary standard information contract) and auditing (to improve the *ex post* policing of contracts).

Regulation may involve either self or statutory regulation. Resistance to statutory approaches to regulation have focussed very much on the notion that legislation will impose minimum requirements which will encourage compliance with the letter rather than the spirit of regulation. The Cadbury Report opted for a Code of Best Practice rather than statutory measures and Macdonald and Beattie (this issue) support this view. Whittington argues that improvements in financial reporting are a necessary but not sufficient condition for improving corporate governance. For corporate governance to be enhanced users must be motivated and able to use the available financial information. Financial reporting can be facilitated by regulation, but Whittington argues that self-regulation is unlikely to be a permanent solution. If the profession has monopoly power there is a need for a wider body to prevent the abuse of that power; but without monopoly power self-regulation has inadequate enforcement power. Hence, there is a need for at least some legal backing to the regulation of financial reporting. However, it should be borne in mind that differing perceptions about the efficacy of self versus statutory regulation may reflect the complexity of the issues involved.

Ormrod and Cleaver (this issue) make a case for the explicit recognition of contracting as one role of external financial reporting. They point out that the information role of financial reports is only one aspect of the purpose of providing them, financial information also being used in the enforcement of contracts (see Citron, 1992, for a discussion of financial ratio covenants in bank lending). They argue that failure to recognise contracting issues is likely to have a number of consequences for both financial reporting and corporate accountability. Financial reporting may develop as a less appropriate measure for contracting purposes than might otherwise be the case and rapid changes in accounting regulation may fail to take account of implications for accounting-based contracts already written. The result may be shifts in wealth, power and risk between stakeholders. This raises the further issue of how far auditors and directors should themselves be subject to regulation. The Company Directors Disqualification Act of 1986 and the recent move to register and monitor auditors can be seen as attempts to strengthen the control over these participants. However, this is not the place to do justice to these two important topics.

Conclusion

It is clear from the preceding discussion that corporate governance is a multi-faceted activity with each of the facets reinforcing the others. In other words, if the overall system of corporate governance and responsibility has fundamental weaknesses at its core then it is unlikely that tinkering with some of its parts will do much to strengthen the whole.

Proposed changes to the system of governance need to be evaluated in terms of their ability to enhance corporate objectives. Although improvements in external reporting may be a necessary condition for improved governance, it is doubtful that they will be sufficient to improve accountability materially. If it is accepted that financial

reporting plays an important governance role, then there is a case for the regulation of both accounting and auditing. However, the Cadbury Committee Report can be seen as accepting that existing governance is largely adequate and that management is only accountable to shareholders. Moreover, the Report's emphasis on the ability of published information to resolve problems of control seems to reflect the belief that current issues of governance may be simply due to imperfections of information. This may also help to explain why the discussions of governance have been restricted to shareholders and directors and also why there has been an emphasis on voluntary regulation. However, whilst there may be a strong case for statutory support for regulation, particularly if there are ethical questions about the behaviour of some parts of the business community, the nature of the corporate governance problem casts doubt on the ability to ensure that unacceptable actions are revealed. Improved disclosure can be a means of putting pressure on managers, although it has been shown above that the exercise of voice by stakeholders is as important as if not more important than disclosure, difficult though it may be to achieve.

In terms of improving the overall approach to corporate governance, it has to be recognised that there are problems in transplanting governance structures which have been successful elsewhere into the UK, since appropriate systems appear to be historically and politically contingent. Moreover, there are doubts as to the effectiveness of the Japanese and Germanic systems in dynamic market conditions. Nevertheless, there would appear to be a key role for active monitors and product market competition as well as (or with greater emphasis than) competition in the market for corporate control. These outstanding corporate governance problems suggest a number of areas for future research both in respect of issues raised specifically by Cadbury and in respect of corporate accountability and governance in general.

Given the importance of historical and political contingencies in affecting corporate governance structures, further comparative analysis of the key features of differing systems of corporate governance is warranted in order to understand more clearly how they may be appropriate in other contexts. Given the importance attributed to cross-ownership by industrial companies in the Japanese system, examination of such holdings, especially their governance implications, appears warranted in a UK context. There is a need to address the design and monitoring of appropriate executive remuneration schemes to close the gap between directors' behaviour and shareholders' interests. In addition, the following need to be addressed: monitoring of the adoption and disclosure of the Cadbury proposals; comparative analysis of developments in corporate accountability and governance in other countries; analysis of developments in internal control systems to meet new corporate governance requirements, which may also require further conceptual developments; monitoring of the role and effectiveness of audit and remuneration committees; analysis of the use and form of disclosure of going concern conditions; monitoring and evaluation of the role of institutional investors; and evaluation of the regulations pertaining to directors and auditors. This is not an exhaustive list, but if just a few of the above are analysed further our understanding of corporate governance within the context of the UK will be advanced.

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The Corporate Governance Jigsaw

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Abstract—The corporate governance debate in the UK over the last two years has clarified the fact that the corporate governance system is a jigsaw and that the interconnections between all the pieces have to be considered when making proposals for reform. This paper describes different models of corporate governance in the UK, Germany and Japan. In particular, it discusses changes made to the UK model and the weakening confidence in it, particularly in respect of listed companies. After discussing the Cadbury Committee recommendations, the paper offers the conclusion that corporate governance in the UK will only improve if there is a process of ongoing review and a coordinated programme of research.

In the late 1980s, it became obvious from press comment that public confidence in the corporate governance system in the UK, particularly that for listed companies, had weakened sufficiently to require a reassessment of the accepted model to ensure that it would reflect corporate practice in the 1990s. As Williams (Midgley, 1982, p. 44) says:

> the task of shaping the mechanisms of corporate accountability—and the public perceptions of how those mechanisms work— . . . requires continuous sensitivity to the need to match corporate processes to the constantly changing social environment.

The system in the UK appears to be basically sound in that its principles are well known and widely followed and there do not appear to be a significant number of company failures resulting purely from a failure in the corporate governance system. Indeed, Pratten (1991, p. 3–5), identifying business failure, macroeconomic activity, financial failure and management failure as the four groups of explanations for corporate failure, made no specific mention of corporate governance. However, the public perception is that change is called for.

One of the most striking aspects of the debate on corporate governance which has taken place over the last two years has been the public realisation that there is such a thing as a *system* of corporate governance. The relationships in the jigsaw are complex—for instance, the accountability of auditors to investors should not be considered without taking account of the fact that the relationship is itself influenced by whom the investors are accountable to. Although the UK model of corporate governance was internally consistent when first introduced, the various parts have since tended to be considered in isolation. There has been no mechanism for making formal changes to the system as a whole (which is a mixture of law, self-regulation and best practice) because no one body or person is 'responsible' for corporate governance. As a result, the tendency has been for the system to develop formally and informally in an uncoordinated fashion.

In this paper, we describe the models of corporate governance used in the UK, and in two other, quite different, countries (Germany and Japan) to demonstrate the impact which cultural and business environments have on corporate governance and to emphasise the difficulties which could be encountered if parts of one model were to be lifted out of their cultural context and used elsewhere in the world without adequate forethought. We note some of the changes made to the UK model over the last century and describe the weakening of public confidence in the model which has occurred over the last ten years. We then describe the Cadbury Committee initiative in response to this public concern and offer the conclusion that the system of corporate governance in the UK will only maintain its credibility in the long term if there is a process of ongoing review of the system and a coordinated programme of research into the issues.

Models of corporate governance

When considering models of corporate governance, a useful starting point is Tricker's definitions of management and governance (1984, p. 7), namely that, if management is about running the business, governance is about seeing that it is run properly. Governance identifies rights and

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responsibilities, legitimises actions and determines accountability (1984, p. 8).

Tricker (1984, p. 7) explains the corporate governance process in terms of four principal activities:

- *Direction*. Formulating the strategic direction for the future of the enterprise in the long term.
- *Executive action*. Involvement in crucial executive decisions.
- *Supervision*. Monitoring and oversight of management performance.
- *Accountability*. Recognising responsibilities to those making a legitimate demand for accountability.

The first two activities are management functions whereas the latter two are governance.

This analysis focuses on the processes in governance rather than on the structures through which it is carried out. The differing historical development of companies and cultural environments which exist from country to country result in different models of corporate governance. Also, the models within each country have to change over time to take account of changes in these corporate and cultural environments. Considering models other than that of the UK may stimulate ideas for changing the UK model but care would have to be taken to research the implications of using part of a model in a different cultural and corporate environment, with particular regard to the legal situation and financial markets. Too simplistic an approach to this would be dangerous.

The UK Model

The classical UK model of governance, which first came into being by way of the 1844 Joint-Stock Companies Act, as illustrated by Tricker (1984, p. 14), is shown in Figure 1. The underlying concepts, which are enshrined in company law, are that:

- the company is a legal entity quite separate from its owners;
- the power to govern the company is derived from ownership;
- the company exists in perpetuity since its shares may be transferred;
- the board oversees the running of the company and reports regularly to the members on the stewardship of their investment; and
- independent auditors, appointed by the members, report on whether the financial statements show a true and fair view.

Other limited duties are imposed on directors, requiring, for instance, the keeping of certain records and the filing of some information. Beyond that, the directors are left to themselves to decide how best to run the company. For instance, there is no distinction in law between executive and non-executive directors nor is there a requirement to separate the chairman and chief executive roles. Also, other than a basic minimum, there is little legal guidance on the carrying out of the audit function, nor is there any requirement to involve employees in the running of the company.

Figure 1
UK Governance Model

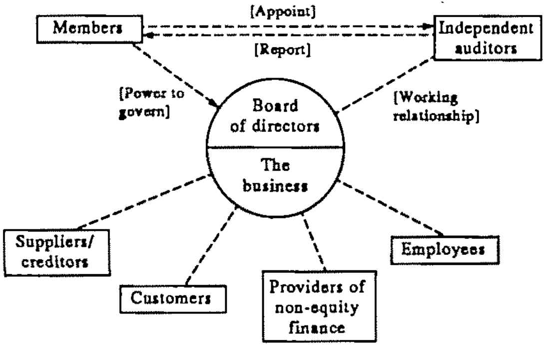
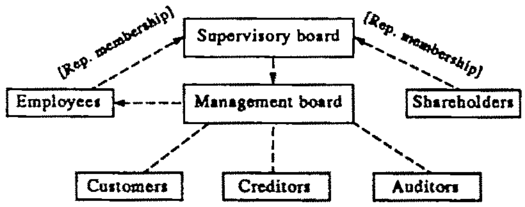


Figure 2
German Governance Model



The German Model

A different pattern of corporate governance is evident for public companies in Germany, where the board structure is illustrated by Figure 2. Tricker's differentiation between governance and management is quite clear in this diagram and from a description of the respective responsibilities of the two boards.

The Supervisory Board has no executive power over direction or executive action, but it exercises its authority by the right to appoint, approve or remove the Management Board. The accountability role is fulfilled by a representative membership of the Supervisory Board elected by shareholders and employees. The Supervisory Board *cannot* take part in the active management of the company so the Management Board must report to the Supervisory Board at regular intervals on matters of policy, profitability, the course of business,

turnover, the state of the company's affairs and any transactions of significant importance for the company.

Why has this structure, which is so different from the UK one, developed? Partly it can be explained by the fact that German law has followed the prescriptive pattern of Roman law. This resulted in far tighter regulation of limited companies from the time of their formation in the nineteenth century than was the case in the UK. Fogarty (1965, p. 42–43) identifies the drafting of the Nuremberg Code in the late 1850s as being the point at which the characteristic German distinction between a supervisory board and an executive board was first discussed. However, it was not until the early 1920s that supervisory boards were first set up, in reaction to the demands for workers' rights which were a part of the revolutionary situation in Germany following the end of World War I.

The different structure is also explained, however, by the different capital market structures in the two countries. It has been traditional in Germany for companies to raise funds from banks rather than from public subscription as has been the case in the UK. As banks in Germany have the opportunity to appoint representatives to the Supervisory Board, those who have invested funds in the business can have a direct influence over the governance of the company and thus can obtain, directly, information about the stewardship and effectiveness of their investment. This is evidenced by the different purpose for which financial statements are prepared in Germany compared to that in the UK. In the UK, financial statements are traditionally viewed as a stewardship document whereas in Germany financial statements are prepared mainly for tax purposes.

We believe that the recent corporate governance debate in the UK has been weak in that there has not been a proper consideration of whether the use of the two tier board system would be beneficial in the UK (ICAS, 1992b, p. 1). Arguments against its use have centred on the proposals contained in the proposed EC Fifth Company Law Directive 'The Structure of Public Limited Companies', principally because the draft Directive includes proposals for employee involvement in the running of the company. An objective appraisal of the issues would be worthwhile for the longer-term consideration of corporate governance in the UK.

The Japanese Model

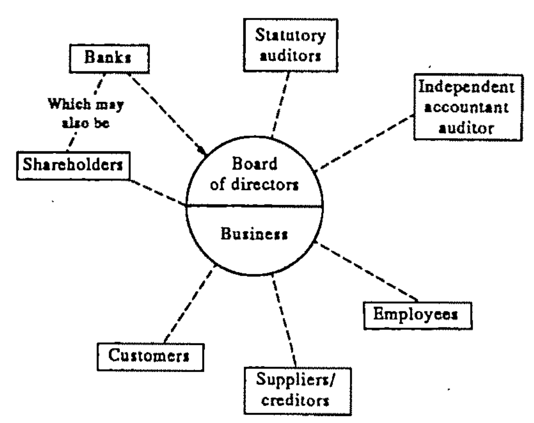
The Japanese model, shown as Figure 3, is similar to the UK model in that it has a one tier board system but, on the basis of Cooke and Kikuya's analysis (1992, p. 36), one could argue that it is perhaps more closely aligned in practice to the German model because of the influence of banks in corporate governance.

Until the late 1980s, it was not uncommon for companies to deposit cash in interest-bearing time accounts to maintain satisfactory relationships with the banks in case banking support was needed at some future date. Banks frequently own shares in companies and are often one of the ten largest shareholders of a public company. Financing through commercial banks and other financial institutions accounted for nearly 90 percent of the external funds raised by companies in the late 1980s (Ernst & Whinney, 1988, p. 19). This figure is high because banks are the main repository for individual savings, which amount to as much as 20 percent of income.

This mutual interdependence between banks and companies led to the banks becoming involved in major investment decisions of the company. Although the banks may have had considerable power to influence the way in which the company was run, it is interesting to note that this opportunity arose mainly from the bank being a major financier rather than through being a shareholder or, as is the case in Germany, through being represented on the board of directors (as this only seldom occurs in Japan). However, equity financing became prevalent in the late 1980s resulting in the beginning of a loss of influence by the banks.

Mochizuki (1992, p. 26) contends that there is now a lack of corporate governance in Japan. Two reasons for this can readily be seen. First, the Japanese approach to shareholder activism is that it is disturbing and detrimental to corporate welfare. This situation was noted prior to the change in the banks' role, by Abegglen and Stalk (1985, p. 184) who likened the role of the Japanese shareholder in the management of the company to that of a preferred shareholder in a US company. Dividends are paid as a percentage of the par value of the shares in the company. Thereafter, the shareholder has little or no further voice in corporate affairs. The second reason flows from this in

Figure 3
Japanese Governance Model



that the disconnection between the shareholders and the board has led to management and the board becoming fused, with all board members being insiders in the sense that they are managers as well as board members.

The informal information flows which result from the role of 'insiders' and the lack of influence of shareholders means that there is less need to communicate information via the corporate report or employee reports than is the case in other countries and particularly compared to the UK. In Japan, there is a two tier system of financial reporting—that required under the Commercial Code, the underlying objective of which is creditor and current investor protection, and that required under the Securities and Exchange Law for the protection of general investors, i.e. future potential investors, the latter having more detailed requirements.

As far as audit is concerned, there are two types of auditor which a company may be required to engage—statutory auditors and independent accountant auditors. The rules on appointment and responsibilities differ depending on the size and type of company. The statutory auditor is responsible for auditing both the financial statements and the operations of the company, i.e. monitoring the activities of the directors in the discharge of their duties and ensuring that no fraud or illegal acts take place. The accountant auditor's role is to audit the company's financial statements.

It is difficult to envisage how aspects of the Japanese system of corporate governance could be drawn into the UK model, particularly given the strong cultural differences concerning employee involvement in the company. However, the use of two different types of auditor for two different purposes is perhaps worth pursuing as a strengthening of the role of the internal auditor in the UK. The distinction between current and general investors is also a concept worthy of thought in the UK context given the public questioning of the decision in Caparo.[1]

Changes made to the UK model

Formal legal changes to the classical model of corporate governance in the UK have taken place throughout the twentieth century. For instance:

- *accounts* The Companies Act 1981 (now incorporated in the 1985 Act) introduced into law the five fundamental accounting concepts—going concern, consistency, prudence, accruals and individual valuation.
- *audit* The 1948 Act stipulated that the company auditor must be a suitably qualified professional accountant and laid down duties, powers and responsibilities for the auditor.
- *directors* Although there is no maximum number of directors which a company can have, the 1985 Act does establish a statutory minimum.
- *meetings* The 1989 Act provides for the auditor's remuneration to be fixed by the company in general meeting or in such manner as the meeting determines.

Alongside formal changes such as these, the classical model has also developed informally over the years by means of the development of practice and the evolution of self regulation:

- *accounts* In recent years, the nature of the financial reporting function has been seen in wider terms than the traditional stewardship role. Lee (1986, p. 139) explains that the audience for financial reports is now perceived to be wider than previously envisaged (information users include shareholders, lenders, bankers, suppliers, government, employees, and all the various experts who provide information to these groups) and that the information needs are correspondingly greater (there appears to be general agreement that this centres on decisions of various types).
- *audit* It was not until 1961 that company auditors received any formal guidance on auditing practice. From that time, audit practice ceased to be purely a matter of the professional judgment of the individual and became, instead, a function with a generally accepted body of principles and practices. Also, a number of court cases established the matters for which the auditor can be held responsible and to whom a duty of care is owed.

The effect of the various formal and informal changes made over the years to the 1844 model of corporate governance, and especially the fact that most of the changes have been made in isolation without considering the effect on other parts of the corporate governance jigsaw, leads us to believe that the model may no longer be internally consistent.

[1]Caparo Industries v. Dickman and Others, 1990, All ER 568.

The weakening in confidence in the system

It is this lack of consistency which explains why there has been public concern about corporate governance in the late 1980s and early 1990s. The weakening of public confidence is evidenced by the following examples:

Types of Shareholder

The classical UK model of corporate governance was introduced when most shareholders were individuals located close to the business. In the modern public company, shareholders may be geographically dispersed, have quite different sizes of shareholding and have completely different reasons for investing in the company. For instance, Shanagher (1991) states that in the UK approximately three out of every four shares are now held by institutions. Tension may arise if the company is taking a long-term view whilst the institutional shareholder considers that its responsibilities as trustee oblige it to adopt a more short-term approach.

The Financial Reporting Function

As explained above, accountability is a fundamental part of corporate governance. However, in recent years, company accounting has been the subject of a great deal of criticism. There has been a widespread view that present forms of financial reporting are inadequate in today's environment. This has sprung partly from a failure to ensure that financial statements continue to provide the information required (however defined) by those (however defined) who have a right to receive such information. It is also a result of the fact that accounting practices, whilst perceived as essentially objective, were in fact capable of being manipulated fairly easily, coupled with accusations that there was insufficient challenge in the audit process.

To Whom are the Auditors Accountable?

Case law has developed over the years to establish to whom the auditor owes a duty of care. The present position is as set in Caparo, where it was established that, in the absence of special features, auditors are not regarded as owing a duty of care to prevent loss to anyone relying on their report except (a) the company, and (b) the shareholders as a body. This decision has been the subject of considerable public questioning.

Company Failures

Over recent years, there have been a number of high profile company failures e.g. Polly Peck, British and Commonwealth and the Sock Shop. Why have cases such as these occurred? Pratten (1991, p. 60) concludes from his case study analysis that company failure should be seen as a subsidiary problem, the underlying problem being the competitiveness of UK firms. He believes that the qualifications placed in auditors' reports are not a fundamental factor determining company failures.

However, we believe that the lack of internal consistency in the corporate governance framework has hindered a proper *public* discussion of the reasons for such failures. An example is the situation concerning the relative responsibilities of the directors and auditors over the going concern assumption. The Companies Act 1985 places on directors the duty to prepare financial statements for each financial year, the amounts disclosed being based on the presumption that the company is carrying on business as a going concern unless the directors know that presumption to be false. There is thus no explicit legal requirement on directors to satisfy themselves as to the appropriateness of the going concern basis. This can be contrasted with the professional guidance set out in Auditing Guideline 410 'The Auditor's Consideration in Respect of Going Concern' which places upon auditors wider duties than those of the directors in this respect, a situation which cannot be sensible.

A reason which is sometimes put forward for sudden company failures is that the directors did not have proper control over the business. Part of the directors' legal responsibilities are that they should maintain accounting records to enable them to disclose with reasonable accuracy, at any time, the financial position of the company. The directors' responsibilities in this respect are the same regardless of the size of the company. The Institute of Chartered Accountants of Scotland's discussion document (1992a, p. 6) argued that, to have reasonable assurance that they were discharging this responsibility properly, the directors (in all but the smallest companies) must have to maintain on a continuous basis some form of internal control system over the company's processes of financial management. The lack of an explicit legal requirement was thought to be unhelpful as it left directors unclear as to the extent of their responsibilities.

Competitive Pressures on Companies and Auditors

In theory it is the shareholders in general meeting who appoint, and fix the remuneration of, the auditors. However, in practice it is the company directors who undertake such tasks. One result of this is that it leaves the directors open to accusations that they have too cosy an ongoing relationship with the auditors to be able to review their appointment and remuneration objectively. An example could be where the directors agreed to an artificially low bid from an audit firm whilst suspecting that a proper audit could not be carried out for that fee. The Auditing Practices Board (APB) (1992, p. 11) has identified the method of

appointment and re-appointment of auditors as lying at the heart of the perceived lack of independence in the attitude of auditors and in the conduct of their relationship with directors. The APB has put forward various suggestions for dealing with this problem.

Recognition of a common problem

So, by the end of the 1980s, it was common to see press comment on: company failures; audit firms being sued after such collapses; the use of creative accounting techniques; whether companies should combine the roles of chairman and chief executive; the use and role of non-executive directors; and so on. For the first time, however, there was recognition that the corporate governance framework had to be reviewed as a whole if public confidence in the system were to be restored.

Recognition of the need to look at the whole complex jigsaw was the major theme of a speech given in November 1990 in London. Professor Ian Percy (1990) said:

> I believe it is now time for our profession, together with government and other agencies, to review the whole concept of corporate governance and its effectiveness in this country.

Following this, it was agreed that the debate on corporate governance would best be taken forward by the formation of a working party comprising representatives from appropriate bodies.

This stimulated the setting up of two committees. In April 1991, The Institute of Chartered Accountants of Scotland announced the formation of a working party to consider three corporate governance issues of particular relevance to the accountancy profession:

- directors' responsibilities for financial statements,
- the need to require companies to maintain adequate internal control systems, and
- the implications of these issues for the role of audit committees.

The results of that working party's deliberations (1992a) were to be input to the second body, the Cadbury Committee, which was set up in May 1991. This was set up by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance.

The Cadbury Committee issued its Report 'The Financial Aspects of Corporate Governance' in December 1992. It is directed to listed companies registered in the UK, but other companies are encouraged to meet its requirements. Several of the recommendations address the problems outlined above. In each case, consideration of the problem was dealt with by looking at it within the context of the overall framework.

One of the most difficult issues the Committee had to address was how to enforce its recommendations. It has already been explained that the system of corporate governance in the UK is a mixture of law, self-regulation and practice which has developed over many years. The players in the corporate governance arena are directors, accountants, lawyers, shareholders etc and, as a result, no one body is responsible for corporate governance.

The easy answer would have been to have opted for statutory backing for the Committee's proposals. However, there were two problems with this option. First, the Committee believed that statutory measures would impose a minimum standard of governance with the risk that boards would comply with the letter, rather than the spirit, of the requirements (1991, p. 12). Second, the Government had made it quite clear that it did not see legislation as the answer to the problem. The then Minister for Corporate Affairs, John Redwood (1991), said

> ... good company governance rests on people ... laying down in regulations idealised models of boards would not guarantee that the right people sat on them or dared to ask the essential questions ... The essence of shareholder democracy is eternal vigilance. The essence of good corporate governance is good corporate board making ...

The Committee therefore opted for the use of a Code of Best Practice designed to achieve the necessary high standards of corporate behaviour. By adhering to the Code, companies would be strengthening both their control over their businesses and their public accountability. In so doing, they would be striking the right balance between meeting the standards of corporate governance now expected of them and retaining the essential spirit of enterprise (1992, p. 11).

Conclusion

We have argued that the various parts of the system of corporate governance in the UK have tended to be considered in isolation with the result that the tendency has been for the system to develop formally and informally in an uncoordinated fashion. Regardless of the significance of the individual recommendations contained in the Cadbury Report, the importance of the Report in an historical context has been twofold:

- it considered corporate governance issues in a coordinated way, and

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- the Committee recommended (1992, p. 18) that its sponsors should, in two years' time, appoint a group to examine how far compliance with the Code had progressed and to consider whether the Code needed to be updated to keep in line with emerging issues. This was seen as the first stage of an ongoing review programme. In other words, the jigsaw would be monitored as a whole.

It is vitally important, however, that the monitoring of the system of corporate governance should involve, if necessary, more fundamental change. Consideration of such issues would be aided considerably by a coordinated research programme, part of which should involve a thorough assessment of aspects of corporate governance in other countries. However, our brief consideration of the corporate governance models in Germany and Japan has highlighted that these models are quite different from the UK model for particular, cultural reasons and has made clear to us that using ideas from other cultures without due consideration may be fraught with danger.

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Corporate Governance and the Regulation of Financial Reporting

Geoffrey Whittington*

Abstract—This paper examines the inter-dependent role of corporate governance and financial reporting within the institutional context of listed companies in the UK. Four related issues are addressed: the nature of the current problems of corporate governance, the role of financial reporting as a palliative for these problems, the need to regulate financial reporting if it is to fill this role, and the form which such regulation is likely to take. It is concluded that improvements in financial reporting may be a necessary condition for improved corporate governance, but they may not be sufficient. Improvements in financial reporting are likely to be facilitated by some form of regulation, because of the need to devise a standard form which will aid inter-firm comparisons. Self regulation by professional bodies has emerged as the initial method of regulation, but this is unlikely to be a permanent solution. If the professional body has monopoly power, there will be pressure for a wider form of private sector regulation, including other parties (such as users of accounts), in order to prevent abuse of monopoly power in favour of the profession. If it lacks monopoly power, the self-regulation will have inadequate enforcement power, and this will lead to calls for legal backing from the state, which will involve a degree of public regulation.

Financial reporting is an important element of the system of corporate governance, and some failures of corporate governance may therefore be due to inadequate financial reports. On the other hand, some problems of the financial reporting process (such as possible lack of auditor independence) may have their origins in deficiencies of the system of corporate governance. Thus, any consideration of how financial reporting might be improved has to have regard to the system of corporate governance within which it operates. This will determine both the appropriate form of financial report and the means (e.g. the form of regulation) by which such financial reports can best be obtained.

This paper addresses four related issues in this area: the nature of the problems of corporate governance which are currently being debated, particularly in relation to listed companies in the UK; the role of financial reporting as a remedy or palliative for these problems; the need to regulate financial reporting if it is to fulfil this role; and the form which such regulation is likely to take.

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Corporate governance: current concerns

The appointment of the Cadbury Committee on corporate governance, which published two reports in 1992 (an interim report in May and a final report in December), is symptomatic of the current concern about corporate governance in the UK. The related issues of corporate reporting and auditing have been considered, respectively, by the Dearing Report (1988), which led to the foundation of the Accounting Standards Board (ASB), and by the Consultative Committee of Accounting Bodies (CCAB) (1991) in its decision to create the Auditing Practices Board (APB). These developments are all related by a common concern as to the adequacy of the provision of financial information as part of the wider system of corporate governance.

There have been at least four separate themes in recent concerns about corporate governance:

(1) *Creative accounting*. The obvious increase in the use and variety of creative accounting methods in the 1980s (e.g. Griffiths, 1986) reinforced these anxieties about the effectiveness of shareholders and their stock market behaviour as a medium of corporate governance. Clearly, managements were going to considerable expense to represent performance as measured by the accounts in an unduly favourable light. This suggested either that shareholders could be fooled by creative accounting or that directors thought wrongly that they could be fooled.[1] In either case, there would seem

[1]Strictly, this applies only to creative accounting which involves form of presentation rather than disclosure of substance. However, much creative accounting is of the former

to be some failure in the shareholders' capacity to monitor directors.

(2) *Business failures*. The public imagination is often stimulated by particular *causes célèbres*, and there have been a number recently which have suggested failure of corporate governance, and have involved associated criticism of auditing and accounting practices. These include the business failures of Polly Peck, the Bank of Credit and Commerce International (BCCI), and the Maxwell companies. They have served as a focus for wider criticisms of the system of corporate governance, although it is not clear that any system will or should prevent business failures in a recession, or that it is possible to provide a guarantee against fraud (which has been alleged in two of these cases).

(3) *Directors' pay*. The rapid increase in directors' pay, associated particularly with the expansion of stock option schemes on a rising stock market in the mid-1980s, gave rise to considerable concern that directors were able to increase their own pay at the expense of shareholders, and without any obvious constraint.[2] This concern was reinforced by the very large pay increases accruing to senior managers and directors when former state-owned corporations were privatised.

(4) *Short-termism*. It is often alleged that British industry fails to invest for the long term, and this is attributed to the short-term pressures on management imposed by the stock market. These are believed to include an undue emphasis on the short-term performance of companies, a failure of which can lead to opportunistic take-overs. The reliability of stock market values as an indicator of the underlying profit potential of firms was brought into question particularly by the stock market crash of October 1987, although there is also an accumulating empirical literature on failures of stock market efficiency, and a theoretical literature on the limitations of informationally efficient markets.

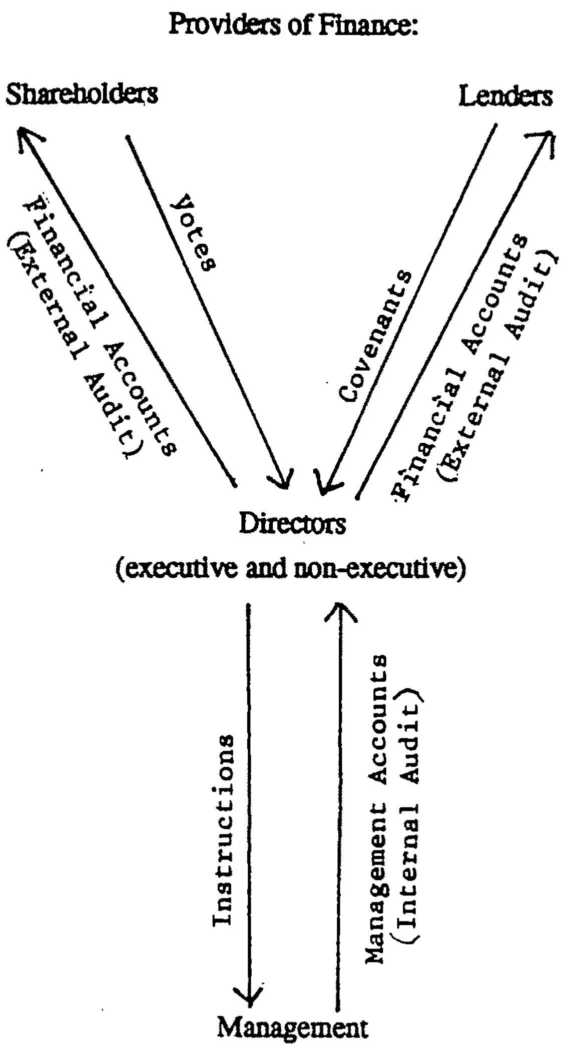
The above four themes may be described at best as symptomatic rather than systemic, i.e. they may be signs that the system is not working well, but they do not identify the fundamental problems of the system. In order to identify such problems, we need to examine the system itself.

The system of corporate governance

The system of corporate governance which is considered here is that currently existing in large listed companies in the UK. More broadly, it may be defined as the Anglo-Saxon model, because similar forms exist in many English-speaking countries, such as the USA, Australia, New Zealand and Canada. We shall focus on the relationship between providers of finance and management, and constraints imposed by government, through taxes and regulations, will be ignored.

The essence of this system, which is summarised in Figure 1, is that the shareholders are the ultimate proprietors of the business, who have the power to appoint and monitor the directors and the right to share in the residual earnings stream of

Figure 1
A schematic view of the UK system of corporate governance



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type, and should therefore be 'seen through' by a semi-strong efficient market. It is also possible that readers of accounts filter data by general rule of thumb adjustments, e.g. to allow for the fact that earnings per share are generally inflated in the UK relative to the USA. However, such general rules cannot identify the extent of the bias in individual cases.

[2]Egginton, Forker and Tippett (1989) propose an alternative method of awarding stock options which would relate reward more closely to performance.

the business by receiving dividends. Providers of loan capital do not have these rights and powers, but they can constrain the actions of directors through loan covenants (which, if violated, can lead to serious restraints on management; Citron (1992) provides recent evidence on loan covenants in the UK) and they have a right to specified interest and capital redemption payments. In recent years, the distinction between loan stocks and shares has become less clear as the result of the evolution of complex securities such as convertibles which have some equity and some loan characteristics.

In order to monitor directors, shareholders and, to a lesser extent, providers of loan capital need information, there being a fundamental asymmetry of information between the directors, who have access to management information, and providers of finance who are external to the company. Financial accounts are a means of relieving this asymmetry, by providing reports from the directors to providers of finance, and the external audit process provides an independent check on the quality of these reports, thus limiting the effects of the moral hazard problem to which directors might be susceptible. A further monitoring device to control executive directors is the existence of a strong, independent group of non-executive directors (as proposed in the Cadbury code), or alternatively a two-tier board of directors such as exists in large companies in the Netherlands and Germany.

Directors, in turn, have to monitor management, and some management accounts serve this process by passing information from managers to directors, as well as being a basis for decision making and rewarding managers. The management accounts, in turn, are often validated by a process of internal audit. In a highly devolved management structure, such as that of certain conglomerates, the role of the central board of directors in relation to subsidiaries becomes more like the relationship between shareholders and directors, being confined to assessing broad financial targets, although control is unlikely to become so loose or to be based upon such restricted data as the financial accounts.

Systemic problems of corporate governance

We can now address more precisely the fundamental, or systemic, problems of corporate governance which underlie the symptomatic problems described earlier.

(1) *Supply of accounting information.* Financial accounts form a crucial link in enabling providers of finance to monitor directors. Imperfections in the financial reporting process will therefore cause imperfections in the effectiveness of the system of corporate governance. The existence of creative accounting is evidence that financial reporting may not be fulfilling its role correctly. This should, ideally, be corrected by the working of the external auditing process, but lack of auditor independence may prevent this. Thus, the recent criticisms of financial accounting and auditing are closely linked to the issue of corporate governance, and it is therefore not surprising that accountancy bodies were involved in the setting up of the Cadbury Committee.

(2) *Demand for information.* The supply of good information will not prevent a failure of monitoring by shareholders, if the shareholders fail to use the information. A barrier to shareholders using information is the cost of processing it. Particularly for the small shareholder, such costs may be large relative to the prospective benefits. The traditional answer to this problem has been the semi-strong form of the Efficient Markets Hypothesis (EMH), which suggests that the small shareholder will free-ride on the sophisticated judgments of larger professional investors in evaluating publicly available information. However, this does rely on the assumption that the EMH holds, and there is an expanding empirical literature on apparent departures from it.[3] Moreover, the EMH refers only to informational efficiency, not to fundamental efficiency (i.e. the market's ability to assess the future cash flows and other fundamental features of a firm's economic performance), whereas good corporate governance, from the perspective of the whole economy, should preferably refer to the fundamentals of the firm.[4] Hence, the EMH does not preclude possible problems such as short-termism.

(3) *Monitoring costs.* Apart from information processing costs, shareholders might incur very significant costs in exercising their monitoring function, particularly where shareholdings are diffuse. In order to influence the directors, the shareholders must combine with others to form a significant voting group which can pose a real threat of carrying resolutions or appointing directors at a general meeting. The costs of combining in this way might well be prohibitive relative to the benefits. There are two possible solutions to this problem within the present system of corporate governance.

Firstly, large institutional shareholders may combine, formally or informally, to exert control on directors by the exercise of block voting power. This is analogous to the protection which such investors can give to the small investor through their information processing activities, if they

[3]Seminal studies in this area include Basu (1977), Shiller (1981) and De Bondt and Thaler (1985). Dimson (1988) includes some recent evidence from the UK.

[4]The classic statement of this argument is Keynes (1936), pp. 150–64. More recent statements, in the context of the EMH, are Whittington (1978) and Summers (1986).

make the market efficient. In some systems of corporate governance, such as that in Germany, the voting power of small shareholders can be pooled by banks who hold proxies and exert a similar discipline on directors through their power to elect members of the supervisory board.[5] In the UK, current institutional arrangements for pooling shareholder voting power are weak and informal.

Secondly, the take-over mechanism can give shareholders the opportunity to exercise their voting power in the decision as to whether to accept a hostile bid. This has long been a theme in the Anglo-American literature on corporate governance (e.g. Marris, 1963), and hostile take-overs have been an important activity in both the USA and the UK in the past thirty years. However, the take-over mechanism is a somewhat blunt instrument. The threat of take-over to be effective requires a well-informed prospective bidder, and sufficient under-performance by management to justify the costs and risks of a bid. Moreover, many empirical studies have questioned the effectiveness of take-overs in bringing better returns to shareholders of the combined group. Directors may be tempted to make take-over bids for defensive or other self-interested motives, since typically they are not required to consult their shareholders before making a bid. This may explain why the typical take-over appears in the short-term to benefit the shareholders of the taken-over company (who do have the option of rejecting the bid) rather than those of the bidding company (Davidson, 1985). There is a growing body of evidence that mergers do not improve the economic performance of the combined group. An early UK study by Meeks (1977) showed that the post-merger profitability of groups did not compare favourably with pre-merger profitability, and there have been many studies of the effect of mergers on shareholder returns. Roll (1986) surveyed empirical findings for the US and concluded that the evidence was consistent with a 'Hubris' hypothesis: that bidders typically pay excessive amounts for take-overs. A recent survey of the empirical evidence on effects of take-overs in the UK concludes that:

> Takeover, or the threat of it, as a disciplinary stock market device leaves a lot to be desired. ... The disciplinarians are bigger and faster growing but not on average more profitable, and their shareholders gain little or even lose as a result of their companies' acquisitions. The shareholders of acquired companies on the other hand make windfall gains that on average have no counterpart in improved resource use or corporate profitability. (Hughes, 1991).

The contribution of financial reporting

If the above analysis is accepted as an account of the current system of corporate governance for listed companies in the UK, we can interpret both the role of financial reporting and its potential contribution to improving corporate governance. We can also observe how the problems of financial reporting are in some respects a product of the system of corporate governance.

Financial reporting, as defined in Figure 1, is a crucial element which is *necessary* for the corporate governance system to function effectively. Without good financial accounting information, providers of finance cannot monitor directors' performance effectively (and equally, without good management accounting information, directors cannot carry out their monitoring and decision-making functions effectively). However, we have already seen that the provision of good financial reporting information is not a *sufficient* condition for the effectiveness of corporate governance: in terms of the earlier discussion, an adequate supply of information will not be effective if there are problems on the demand side (users do not process it), or if the informed user is unable to exercise a monitoring role (due to high monitoring costs). Thus, whilst improved financial reporting might play a role in the improvement of corporate governance, it cannot guarantee it and is certainly not a panacea.

In the remainder of this paper, we shall consider the current problems of financial reporting, why they may need to be dealt with by regulation, and the form which such regulation might take. These problems are considered within the context of the system of corporate governance, because it is that which defines the nature of the problem. However, it is important to emphasise that alleviating the problems of financial reporting does not represent a complete cure for the difficulties of the underlying corporate governance system. This would involve addressing additional issues to that of the supply of accounting information.

Current problems of financial reporting

The issues in financial reporting which are regarded as 'problems' are well known and have been discussed in a previous paper (Tweedie and Whittington, 1990). Essentially, current accounting practice allows a degree of choice of method in determining the method of measurement, criteria for recognition, and even the definition of the accounting entity, on which financial reports are based. The exercise of this choice to improve the

[5] Cable (1985) provides a statement of this view of the role of German banks. Edwards and Fisher (1991), provide a thorough review of the empirical evidence. They conclude that there is some evidence in favour of this view but that it 'cannot be acepted without qualification'. For example, they cast doubt on the effectiveness of supervisory boards.

apparent performance and state of a business is popularly known as creative accounting. Its targets are often one of two variables, earnings per share (a crucial ingredient of the Price/Earnings ratio used widely by investment analysts) and the gearing ratio (the ratio of Debt to Equity, often used as a measure of financial solvency, widely believed to be relevant to lending decisions, and sometimes incorporated in debt covenants). Its techniques are many and varied, but they include off-balance sheet financing, the use of complex capital instruments, and several different aspects of accounting for mergers and acquisitions.

Insofar as creative accounting imposes extra information processing costs on users and, in the extreme, involves non-disclosure of information, it can contribute to the problems of both the supply and the demand for accounting information which were discussed earlier in the context of corporate governance. However, before we can conclude that the correct remedy for this is the imposition of accounting standards by means of regulation, we must address the question of whether creative accounting is the result of a market failure, or whether it is a correct response to the current conditions of supply and demand in the market for accounting regulation.

The free market solution, and its limitations

The free market view of the provision of accounting information, as proposed, for example, by members of the Rochester School (e.g. Watts and Zimmerman, 1986), emphasises the role of *contracting* between providers of finance and corporate management (represented in our model by the directors). It is argued that companies would not be able to raise capital, or would have to do so on extremely unfavourable terms, if they did not offer contractual terms which would enable providers of finance to monitor performance to insure against incompetence or dishonesty by management. Part of such terms will be provision for the supply of financial information and its audit. Free competitive contracting between the parties should mean that the information is well designed for its purpose and that the quantity is optimal in terms of the cost/benefit trade-off. The same considerations would apply to the *audit* function, which provides a necessary independent check on the quality of financial reports, and therefore ensures that the terms of the information contract are fulfilled *ex post*. Another important *ex post* check on management in this framework is provided by the EMH, which implies, in its semi-strong form, that the market 'sees through' any creative accounting which affects the form of presentation. If the EMH holds in its strong form, then all available information, including insider information which is not disclosed in the accounts, is reflected in stock market prices.

The obstacles to the free market model working in practice are as follows:

(1) *Contracting costs*. The difficulty of shareholders combining to produce a common policy, where holdings are diversified, has already been referred to. Since accounts are addressed to a wider audience, the problems of satisfying all users are even more complex, even if (as in the contracting model) we confine attention to providers of finance. There would also be considerable costs on individual providers of finance in appraising the details of the contract. However, the biggest difficulty of all is that *comparability* of accounts across companies is widely regarded as a desirable property of accounting information, since much financial analysis takes the form of comparing an individual company's performance with that of groups of similar companies.[6] Thus it is not within the individual company's power, in isolation from others, to determine its optimal accounting policy. Moreover, many of the benefits of comparability are *external* to the individual company, accruing to potential shareholders or shareholders of other companies. This leads us inevitably to the need for a *standard contract* for the provision of accounting information. Accounting and auditing standards may be regarded as part of such a contract, and they may also be regarded as products of regulation. However, we shall discuss later the form of regulation, which need not necessarily be *public* regulation.

(2) *Problems of ex post implementation*. After the finance has been raised on the promise of *ex ante* contractual terms, the directors who have raised the finance may have strong incentives not to fulfil the contract with respect to provision of accounting information, since this will loosen the monitoring constraints on them. In the case of information, the incentive is particularly strong, because it is the nature of misleading information that the recipient is misled and the provider of information is not found out.

This problem is compounded if, as suggested earlier, shareholders have high information processing costs and therefore do not apply the effort necessary to 'see through' some forms of misrepresentation. If the EMH holds, such shareholders are able to free-ride on the efforts of more discriminating shareholders. However, it has already been noted that there is accumulating empirical evidence that the EMH does not hold, and furthermore that even if it did hold, this would not guarantee efficiency in the 'fundamental' sense which would

[6]The Solomons Report (Solomons, 1989, p. 6) emphasises the importance of comparability as a justification for accounting standards.

be necessary for monitoring the efficiency and effectiveness of management.

There remains the possibility that the auditor might save the situation by ensuring the *ex post* implementation of the accounting information contract. Unfortunately, in practice, there have been obstacles to the independence of auditors. Directors usually have a significant influence on auditors' remuneration, both in directly determining audit fees and in awarding additional work for consultancy and tax advice. Directors also have a decisive influence on the appointment of auditors, given the shareholders' lack of information on the quality of the audit and their general difficulties in organising voting blocks. Furthermore, the co-operation of the directors can make the audit process much cheaper, and the directors (through management letters and other means) are the main recipients of information arising from the audit, whereas shareholders receive only a brief, stylised, single paragraph report. It is therefore not surprising that auditors often refer (wrongly) to the directors of the company as 'the client', whereas legally the client is the body of shareholders who formally elect the auditors and to whom the audit report is addressed. All this takes place against the background of a highly competitive auditing market, in which opinion shopping and low-balling on audit fees may add to auditors' feelings of insecurity. Thus, it may be questioned whether auditing, in practice, currently fulfils the idealised role ascribed to it in contracting theory. A possible remedy for this situation is to change the auditors' relationship with directors (e.g. the Cadbury Committee proposes that they should report to an audit committee of non-executive directors), and another, possibly complementary, remedy is to strengthen the professional regulation of auditors.

Forms of regulation

If the above argument is accepted, then there is a case for the regulation of both accounting (to devise the standard information contract which is needed) and auditing (to improve the *ex post* policing of the contract). Empirically, we may call upon the supporting evidence that accounting and auditing are, in fact, regulated in some form in all advanced free market economies, and that this system seems to have wide support from accountants, auditors and users of accounting information (although individuals will obviously complain about individual instances of regulation which have an adverse effect on their own interests).

An important issue which we have not addressed is, however, the form of regulation. Typically, the oldest and most pervasive form of regulation is *self-regulation*, by accountants, auditors or other preparers of financial information. This has typically been done by professional bodies, in the interests of facilitating the work of their members. An example is the series of Recommendations on Accounting Principles published by the Institute of Chartered Accountants in England and Wales (ICAEW) long before there were any formal accounting standards.[7] These can be interpreted as attempts to devise a standard service contract which members of the profession would follow, thus improving the quality of their product (by improving the comparability and content of financial statements). The regulation of auditing in the UK also developed from the activities of a professional body (the Auditing Practices Committee, APC, of the ICAEW), and is still sponsored by a group of professional bodies (the members of the CCAB), as was the Accounting Standards Committee, ASC, (1970 to 1990).

It seems likely that critics of regulation who take the free contracting view would not object to self-regulation *per se*: their main target seems to be public sector regulation (e.g. see Watts and Zimmerman, 1986, chapter 10). However, there seems, historically, to have been a tendency for self-regulation to develop towards public sector regulation or more broadly-based private sector regulation or a combination of the two. For example, in the UK, the loose self-regulation of the ICAEW's Recommendations was replaced, in 1970, by the Accounting Standards Steering Committee, a more formal body which exposed its views to public comment by all interested parties, including those outside the accountancy profession. As this developed (re-styled as the Accounting Standards Committee, ASC), it gained the support of all leading professional bodies (through the Consultative Committee of Accountancy Bodies, CCAB) and also widened its membership to include more non-accountants, i.e. it became more broadly based, but still in the private sector. Finally, following the Dearing Report (1988), and the 1989 Companies Act, it was replaced by the Accounting Standards Board (ASB) in 1990. The ASB has an even broader base, through its sponsorship and supervision by the Financial Reporting Council (FRC), which represents a wide range of interests in addition to accountancy bodies. The ASB also has a

[7]Zeff (1972), pp. 308–10, discusses the origins of the Recommendations and their counterparts in the USA, Canada and Mexico. He suggests that the prospect of government intervention was probably a factor in the USA, Canada and Mexico, but not in the UK, where the ICAEW's initiative can be explained in terms of the demand for a more standardised accounting product, as suggested here. Zeff cites the pressure from accountants in industry and commerce. He also points out that the Scottish Institute objected in principle to official guidance, but that its members were able to make unofficial use of the ICAEW Recommendations.

degree of government backing, through the legal authority of the 1989 Companies Act and through some government funding.[8]

In the USA, government backing for accounting standards came much earlier. The Securities and Exchange Commission (SEC) was established in 1934, with authority to set accounting standards for companies whose stock or shares were publicly traded. At first the SEC delegated most of this work to a committee of the American Institute of Certified Public Accountants (AICPA) (effectively a form of self-regulation), and later (in 1959) this was re-constituted (partly as a result of SEC pressure) as the Accounting Principles Board (APB), which had more support staff and better representation of users of accounts, and might therefore be described as being more broadly based. In 1973 (again with SEC support) the APB was replaced by the Financial Accounting Standards Board (FASB) which is more broadly based, being a separate entity from the AICPA and drawing its sponsorship from a variety of sources. Thus, the USA, like the UK, has seen a move from self-regulation to more broadly-based private sector regulation, and a degree of government backing for standard-setting has developed in both countries. Similar elements can be observed in the development of accounting standard-setting in the other English-speaking countries, which have similar systems of corporate governance and therefore similar roles for financial reporting, although the precise form and sequence of events varies according to the historical and institutional setting. For example, accounting standard setting has a degree of government backing in both Australia and Canada. In New Zealand and South Africa, on the other hand, accounting standards still rely on the professional bodies for their authority.

In order to understand this process, we have to consider two important potential problems of self-regulation. These are enforcement and independence. We shall argue below that enforcement powers are necessary for an effective standard-setting process. These can be obtained in two ways. A self-regulatory body can enforce standards if it has monopoly power over the provision of the relevant services, so that it can exclude (by de-registration) providers of sub-standard services. However, monopoly power will lead to calls from other interested parties (such as users of the service) for a broader range of interests to be represented in the standard-setting process. This will lead to self-regulation being replaced by more broadly-based private sector regulation which has greater independence from the group being regulated. Alternatively, if the self-regulatory body does not have sufficient monopoly power to enforce standards, it will be ineffective, and those who have an interest in the standardisation of the service will seek government backing for regulation.

(1) *Enforcement*. Members of a profession may be willing to subscribe to a voluntary code, but there will be occasions when following the code conflicts with their own interests, and they will be tempted to break the code in practice, whilst subscribing to the broad principle. In the case of accounting standards, for instance, members of the profession may be tempted to free-ride on the good behaviour of others in creating confidence in accounts: an ideal situation for the selfish individual may be that accounts in general have high credibility because others follow standards, but the individual does not follow standards and thus gains undeserved credibility at the expense of others.

Thus, some form of enforcement is required. This can be done by two means. Firstly, *professional discipline* and secondly *legal backing*. Professional discipline will only be effective against the selfish individual if it has the power to penalise, and this in turn implies a degree of *monopoly power* by the profession. If the profession ultimately has the power and the will to stop the individual from practising if the professional code is violated, this is a potentially powerful incentive for enforcement. If the individual can join another competing professional body or does not require membership of a professional body, then the profession lacks a strong sanction. In this case it will have to turn to *legal backing* for enforcement and this will drive it towards a form of *public sector regulation*, since the state will not usually give legal backing without retaining some control over the exercise of the power.

In the UK, it is notable that the ASC, which dealt with accounting standards which apply to preparers of accounts, whose employment is not conditional upon membership of a professional body,[9] has been replaced by the ASB, which has a degree of legal backing. The Auditing Practices Committee (APC), on the other hand, dealt specifically with auditors, who have to be members of CCAB professional bodies in order to engage in public practice, and neither it nor its successor, the Auditing Practices Board (APB), have required

[8]Turley (1992) provides a review of the new standard-setting framework.

[9]Thus, the ASC's principal enforcement power was that of the CCAB member institutes to require auditors to qualify their audit reports in the case of departure from standards, because the directors could not be required to follow the standards in preparing their accounts. Unfortunately, audit qualifications did not prove to be a powerful weapon, notably in the case of SSAP16 (current cost accounting) in which a note of non-compliance became a routine feature of audit reports (a strict qualification of the audit report was not required for departure from the SSAP16 supplementary disclosures).

legal backing.[10] It is also important to note the role of the CCAB in professional standard enforcement. The professional bodies acting in concert can ensure that all professional auditors (with minor exceptions) are covered by the same discipline so that there is no question of 'opinion shopping' between professional bodies, which might undermine standards set by individual bodies.

(2) *Independence*. This, the second problem of self-regulation, is in a sense the mirror image of the first, because it is most likely to be a serious problem when the self-regulating body has a monopoly. It has long been recognised that members of the same trade or profession combining together can lead to 'a conspiracy against the public' (Adam Smith, 1776). Thus, advocates of the free market approach would be opposed to self-regulation which amounted to the exercise of monopoly power in the interest of the regulators. Similar opposition would come from those who believe that regulation should serve a wider public interest. Recent criticisms of the working of the APC in the UK (e.g. Sikka, Willmott and Lowe, 1989) can be interpreted in this way. For example, it may seem that auditing standards have been designed to limit the liability of auditors rather than serving the needs of users of financial statements (Singleton-Green, 1990).

There are two possible remedies for this problem. The more radical remedy is public sector regulation. The less radical one is broad *private sector regulation*, i.e. the regulated group itself delegates the regulatory functioning to a body which includes users of the service and other representatives of the broader public interest, so that the narrow interests of the regulated groups no longer predominate. The replacement of the APC by the APB can be regarded as being of this type: the APB has many more non-auditor members, representing wider interests than those of the auditing profession. The Take-over Panel, which regulates the conduct of take-over bids, is another successful example of private sector regulation in a related area. This uses the disciplinary power of the Stock Exchange, derived from the ultimate power to suspend the listing of a share, although the Panel represents a wide range of City interests. The Stock Exchange could also provide a disciplinary basis for the closer regulation of financial reports of listed companies, but it has shown little interest in extending its activities in this direction.

[10] Moonitz (1974) is associated with the view that audit regulation is appropriately the province of self-regulation, whereas accounting raises broader public interest issues which require a more broadly based regulatory body. His view is founded on the belief that auditing is a technical matter, which is of limited interest to non-professionals and difficult for them to understand. Recent criticisms of auditing in the UK, and the creation of the APB, which is more broadly based than its predecessor, suggest that these conditions may no longer hold.

Summary and conclusion

This paper has examined the current system of corporate governance of UK listed companies and attempted a diagnosis of its main problems. Accounting plays an important role in the system, and improved financial accounting would provide a basis for improved monitoring of directors by providers of finance. However, improved accounting is not a panacea for more effective corporate governance: this would depend on addressing additionally the other deficiencies which were identified in the system.

The discussion then turned to the current deficiencies of financial accounting, and why these might require to be dealt with by some form of regulation. The need for regulation arises from the need for a standard form of financial reporting which will facilitate inter-firm comparisons. The high individual costs and diffused benefits of devising such a standard form mean that it is unlikely to be provided without a common regulatory agency. Finally, the forms of regulation were discussed. Self-regulation was seen as involving problems of enforcement (particularly if the self-regulatory body does not have monopoly power) and independence (particularly where the self-regulatory body does have monopoly power). In the former case the consequence would be a move towards legal enforcement powers, and therefore to a degree of public sector influence (as in the case of the ASB). In the latter case, a more broadly based private sector regulatory body (such as the APB) would be a natural development.

The main conclusion is therefore that regulation is a natural consequence of the underlying features of the market for accounting information, which are, in turn, determined by the system of corporate governance. The precise form of regulation also should arise from the characteristics of the underlying market for professional services, but self-regulation is unlikely to be more than a transitory stage in the evolution of regulation. Enforcement powers are necessary for successful regulation, in order to prevent free-riders from exploiting the good reputation built up by those who conform with the regulation. The regulatory authority will either seek such powers from the state (public sector regulation) or it will have monopoly power over the provision of some relevant service (as in the case of the audit monopoly shared by professional bodies). In the latter case, there is a danger of abuse of monopoly power in the interest of the self-regulator (as some have suggested in the case of auditing) and this will lead either to public regulation (as some expect in the case of auditing) or to a broader private sector in which wider interests are represented on the regulatory body (as in the case of the UK's recently created Auditing Practices Board).

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Approaching Corporate Accountability: Fragments from the Past

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Abstract—This paper develops a historical perspective on corporate accountability from an analysis of the writings of the English philosopher, Jeremy Bentham. It is suggested that Bentham offers an understanding of accountability which can be insightful today and contribute to current debates on corporate accountability.

Introduction

This paper presents a historical perspective on corporate accountability, developed from analysis of the writings of the English philosopher Jeremy Bentham (1748–1832). It is argued that an analysis of Bentham's texts on accountability and accounting can provide valuable insights for present-day debates, especially suggesting possibilities for the future development of corporate accountability.[1] After briefly introducing Jeremy Bentham, and thus making a case out for the significance of his writings on accountability, an extensive analysis and interpretation of Bentham's understanding of accountability, and the insights it suggests, is offered.

Bentham on accountability

In the history of Western philosophy, Jeremy Bentham occupies a significant place in the development of utilitarianism. His work reflects a broader context including rapid social, economic and technological change and the increased significance of scientific reasoning. Many commentators maintain that his ideas had a considerable impact upon government policy and influenced the formation of many modern institutions and practices. He was a member of several apparently influential circles and his followers occupied key positions in government and the civil service (c.f. Hobsbawm, 1962; Russell, 1962; Foucault, 1979; Hume, 1981; Evans, 1983; Habermas, 1985; Dinwiddy, 1989; Haslam, 1991; Hoskin, forthcoming).

A 'great questioner of things established' (Review, 1838), Bentham pursued a scientific materialist approach which was heavily influenced by the anti-traditionalist reasoning of the Enlightenment. He carried out a profound examination of the nature of thought, language, law, government and public morality, pursuing a quest to discover and prescribe the principles of a legal and social system which would be rational, just and clear.

Bentham thus came to apply principles of utility to the design and re-design of institutions, such as prisons, schools and factories, and to the related development of principles of management. In this regard, the well-known Panopticon principle (or 'all-seeing' principle, Panopticon literally implying an instrument by which all is seen) was his central principle of management. According to the Panopticon principle, which Bentham was concerned to apply extensively with the aim of improving general well-being, people under management performed much better if they could perceive that at any time they might be under surveillance.[2] For Bentham it was an 'indisputable truth' that 'the more strictly we are watched, the better we behave'

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[1]Our approach to history is concerned to be open to possibilities in the past which have somehow been suppressed and perhaps forgotten and which might have been beneficially taken up. In this regard there are similarities between analysing accountability in a 'past' context and analysing it in a 'foreign' context (c.f. Lowenthal, 1985; Haslam, 1991). We are not here offering a blueprint for change. Rather, we are suggesting that a reading of Bentham can offer new insights on corporate governance and accountability. This includes reinforcing contemporary criticisms of corporate accountability, partly by pointing to the historical dimension of such criticisms.

[2]Bentham wrote, for example, that educational systems, should the Panopticon principle be applied therein, would be improved (Bentham, 1816). It might be noted that Bentham's principles appear not to have been universal: he did not encourage others to watch him—he was something of a recluse or hermit (cf. Letwin, 1965).

(quoted in Bahmueller, 1981, opposite title page). Thus the bureaucratic and architectural features of Bentham's model institutions were fashioned with surveillance in mind (c.f. Bentham, UC, cliv, 34, clivb, 406; Bowring, 1843, viii, p. 414; Review, 1838; Russell, 1962; Foucault, 1979; Bahmueller, 1981; Hume, 1981; Ignatieff, 1984; Habermas, 1985; Loft, 1986; Dinwiddy, 1989; Haslam, 1991; Urmson and Rée, 1991).[3]

Bentham's extensive writings on accounting, which we suggest here provide insights into his understanding of corporate accountability, indicate that he associated accounting closely with the Panopticon: accounting could make things visible and thus contribute to surveillance. Accounting is thus very central to Bentham's scientific and administrative thought.[4] And, in effect, he sought to greatly enhance accounting's importance in society (cf. Bahmueller, 1981).

Several studies have pointed to the significance of Bentham's writings on bookkeeping/accounting (Gallhofer and Haslam, 1992, attempt a comprehensive account; cf. Goldberg, 1957; Hume, 1970, 1981; Bahmueller, 1981; Loft, 1986; Walsh and Stewart, 1988; Haslam, 1991; Laughlin, 1992). Here we are concerned to extend this and contribute new insights in exploring Bentham's substantive writings on corporate accountability and in suggesting its relevance for current debate.[5] We analyse Bentham's understanding of corporate accountability here under several headings: the meaning and purpose of accountability, the recipient of information in the accountability process, the unit of account, the form and content of accountability, and the accountability of accounting itself.

The Meaning and Purpose of Accountability

Central to Bentham's understanding of the accountability process was the principle of publicity. This implied that the rendering of an account to a public realm was integral to the process whereby accountability was discharged. Bentham's alternative expressions for the principle of publicity point to the sense in which he was concerned to render bodies and activities open and visible: from Bentham's notes, interchangeable alternatives were the 'open-management-principle', the 'all-above-board-principle' and the 'transparent-management-principle' (cf. UC, cliiia, 154; Bentham, 1799). In Bentham's writings can be found a questioning of the purpose of the accountability process, to which we now turn.

For Bentham, the purpose was to enhance 'well-being'. Thus he understood that accounting publicity, in consequence of its effects on behaviour, could contribute to human happiness. In Bentham, basic individual happiness implied the observance of moral principles, as well as the securing of material welfare: virtuous behaviour is equated to rewarding behaviour and morality and economics are thus combined. By exposing people's activities to view through accounting publicity, Bentham felt that people would better pursue moral and economic duties and hence that their happiness would be enhanced. He wrote in this context that the principle of publicity was a corroborant to all the others that 'act upon the will.. it aids the *will*, by exposing it to the action all that counts [?][6] as punishment and reward, which has public opinion for its source..' (UC, cliiia, 154). In brief, this is consistent with his view that publicity engendered good 'management' or good 'government' (the terms were used interchangeably) whether in the case of the individual, the micro-enterprise or the nation state. In this regard, we might point out that in one of Bentham's texts accounting is explicitly considered to be a branch of ethics (cf. Bentham, 1817, notes to tables).[7]

[3]References to Bentham, UC are to material from the Bentham archive at University College London. The volume number of Bowring's edited works of Bentham is also given in referencing.

[4]It might be pointed out that, by the 1830s, accounting publicity can be considered to be a focus of the scientific discourse of political economy (cf. British Parliamentary Papers, 1831–2 (722), VI, 1 and 1836 (591), IX, 411; Haslam, 1991).

[5]Thus, although Bentham's views are not inconsistent with other conceptions of accounting of the late eighteenth and early nineteenth century, and, although they can be considered to be influenced by earlier conceptions of accounting (c.f. Hume, 1981; Haslam, 1992), we suggest that there are grounds for finding it potentially rewarding to analyse the extensive scientific reasoning on accountability that is apparent in Bentham's texts.

[6]Bentham's handwriting is difficult to read.

[7]It seems that, for Bentham, people cannot be trusted to pursue their happiness as effectively when not under surveillance. This position, which in Bentham is unlikely to have been a fixed one—he wanted to experiment to see how happiness could be achieved—is not perhaps as extreme or unreasonable as it might initially appear. It is quite common for (democratic) governments, of varying politico-philosophical tendencies, to 'observe' people—more especially certain categories of people, such as children—'in their own interests' (more generally to 'control' them—e.g. by making them subject to legislative rules). Further, in the process of general social interaction, one is observed (and controlled)—Bentham is to some extent channelling this for 'well-being' and one might (generously) suggest 'democratising' it. Bentham is breaking down taken for granted distinctions between, for example, 'children' and 'adults' and recognising the sense in which many people, ultimately perhaps the community as a whole, might benefit from being 'watched over' (e.g. people might become happier by becoming more informed, less lazy etc, cf. 'it aids the *will*', cited in the text) (cf. Archard, 1990). In this regard Bentham argued that schools and factories were basically the same as far as concerns principles of management (cf. letter to the Right Hon. John Parnell, Buxton, Derbyshire from Bentham, British Museum Manuscript, 2nd Sep. 1790, MS 33541, f. 160; cf. Foucault, 1979). It should also be noted that Bentham's support of observation would include such moments whereby, for example, individual A's kindness (under surveillance) to indi-

In his text on pauper management Bentham explicitly suggests that if the management of a body (in that case a joint stock company) is subject to accounting publicity then that management will behave well in terms of moral and economic criteria. He expresses this in the language of duty and service to 'humanity' and 'economy'. He seems to argue that the principle of publicity is the optimal mode of securing the duty to humanity in particular and that the securing of this latter duty is the primary role of pp. publicity:

> The duty of the manager.. has two main branches: duty towards those under his care, resolvable into *humanity*—and duty to his principals (the company), resolvable into *economy*. *Publicity*, the most effectual means of applying the force of moral motives, in a direction tending to strengthen the union between his interest and the *human* branch of his duty; by bringing to light, and thus exposing to the censure of the law and of public opinion, every instance of contravention.. (Bentham, 1797, pp. 51–2).[8]

Bentham felt that if a proper system of accountability was in place it would transform the immorality and lack of economy that would otherwise prosper, to the detriment of all. Publicity, in this respect, would meet with an active response:

> .. accounts must be.. published.. regularly—and will be scrutinized.. by many a benevolent.. suspicious.. envious eye; accounts.. giving the most perfect transparency.. (UC, cli, 322; Bahmueller, 1981, p. 187).

An assumption of Bentham's reasoning was that, next to the desire to possess money, the desire to avoid shame was taken to be a powerful motivation for behaviour:

> .. the eye of the public is drawn upon the subject, and operates as a check [upon] personal interest and favouritism (UC, cliiib, 281; Bahmueller, 1981, p. 190).

Bentham's concern that a proper system of accountability would enhance 'economy'[9] in that it would have appropriate impact upon behaviour is worthy of further analysis. Accounting was not just to 'save and preserve' but to 'produce and augment' (cf. Hume, 1970, pp. 24–5). Exposure checked mismanagement, misapplication and waste as much as, if also including, theft. In this regard, the most 'ordinary' management, if subject to publicity, might function effectively and consistently if exposed (Bentham, 1797, pp. 100–1). These were the 'rules' envisaged in Bentham's view that any semi-public company required to publish accounts would be tied to an obedience to 'the rules' or have to provide reasons for departures therefrom (UC, cliiia, 154; cliib, 282, Bahmueller, 1981, p. 187). This perspective is consistent with publicity being constituted by a report on whether a (perhaps broadly defined) prior (economic) target had been met, a notion not peculiar to Bentham in the context, and one which he would not have found exceptional or unusual (cf. British Parliamentary Papers, 1844 (119), VII, I at 1843, q. 1913; cf. Haslam, 1991). Bentham argued that publicity allowing comparison would be especially conducive to economy. He sought to make possible, through accounts, the evaluation of different management practices, this facilitating a 'management-selection principle' whereby the best practices could be more widely adopted to the general community's benefit (UC, cliiia, 153, 154; Ben-

Footnote continued
vidual B is met with reciprocity, thus enhancing the happiness of individual A. In this respect Bentham sought to repress forces of 'evil', which he clearly deemed to exist, and to encourage forces of 'good'. It is not denied, however, that Bentham's principles might be applied extremely. Writers such as Bahmueller (1981) argue in effect that Bentham's principles threaten liberty (cf. Rosen, 1982). And clearly (as, it is again emphasised, in contemporary society) there is a lack of trust in people in general (which indeed risks to be self-fulfilling). Yet, as we suggest above, one can find something of value in Bentham's principles here and several writers in political theory have been reappraising him in this respect in order to defend him or rescue him to some extent from his many critics (cf. Lyons, 1973, 1984; Roberts, 1979; Rosen, 1982). Suppose we envisage a democratic community where, for inter-personal relationships, trust might replace rules—such a society might still decide to impose rules on itself for its own reassurance (each individual may not trust him or herself, in this regard, even if trusting others), these rules including rules of observation. Terms such as 'observation' and 'surveillance' have negative connotations—but one might find a positive dimension to them. Where one is concerned—openly, and democratically—to 'observe' (and more generally, to 'regulate'), with genuinely good intentions, this positive dimension surfaces (a theoretical elaboration—which also stresses that Bentham's 'rules of observation' were to be subject to *democratic* control—can be found in Rosen, 1982—see especially his discussion of Bentham's concept of liberty, pp. 577–8—Lyons, 1973, 1984; and, Roberts, 1979).

[8]Some of Bentham's draft notes explicitly stress, in this regard, a concern to 'fight-the-good-fight' through pragmatically effective principles (cf. UC, cliiia, 154). Compare his view that the principle of '.. publicity or Transparent-management principle regards motives as well as means' (Bentham, 1797, p. 56). This echoes the principles of 'serious Christianity' which emphasised the benefits, in terms of improving morals, of setting up accounting and recording systems in the personal sphere. Arthur Young, who seems to have influenced Bentham's views on accounting, was a practising serious Christian. Relatedly, public accountability was a principle pursued and followed by many religious bodies (cf. Davidoff and Hall, 1987; Haslam, 1991).

[9]It should be noted that 'economy' was then approached more pragmatically than was the case within a few decades after Bentham's writings, when political economy assumed the more abstract form associated with neo-classical economics today (cf. Paul, 1979). One must in general be careful to appreciate the sense in which the terms Bentham used in the historical context are different in their meanings from those of today.

tham, 1797, pp. 50, 102–3; Hume, 1970). Publicity allowing comparison:

> .. strengthens power .. by enabling each of the component establishments [of a sizeable organisation] to receive instructions not only from every other of its fellow establishments but from the enlightened part of the public at large. It shows to each what there is good and bad in every other: that the good may everywhere be adopted and the bad avoided .. (UC, cliiia, 154).

In his elaboration of the meaning and purpose of accountability, Bentham's philosophical and scientific approach conceives accounting to be a flexible instrument of reason. This should encourage us to question rigorously traditional understandings of accountability. In the above, we can already perceive that Bentham's own anti-traditionalist questioning can still be challenging to traditional notions of accountability today. There is, for example, the suggestion here that accounting disclosure should aim explicitly to expose economic failings and even moral ones. The suggestion is that accounts make possible an evaluation of managerial practices and aspects of managerial effectiveness (perhaps against prior targets). Bentham's explicit concerns with economy and his linkage of the accountability process to 'good management' fuse in what today seems like a blurring of the distinctions between external (financial) and internal (management) accounting.[10] That Bentham appears to understand publicity to be more effective as an instrument of securing the duty to humanity than economy should encourage a re-thinking of the role of contemporary accounting. Perhaps more emphasis might be put on whether a corporate body is being governed in accordance with moral principles. Such moral principles (some of which might be within the ambit of law) might today encompass principles respecting, for example, labour relations (including the pay and conditions of labour and principles of equal opportunity), pricing and consumer protection, internal control systems and fraud management, and the protection of the ecological environment. These latter considerations cast doubt as to whether the corporate body is the correct unit of account for all these purposes, a point to which we return latter. And there is also Bentham's understanding of who benefits from an open disclosure in the accountability process. As well as the recipient of information and the public in general, the conveyor of the information is held to benefit particularly in that exposure will transform the conveyor's behaviour in such a way as to enhance the conveyor's well-being. The latter point is worthy of further elaboration here as it points to a sense in which Bentham's conception of accountability differs from many conventional approaches to accountability today.

Firstly, it appears still to be a common conception that the conveyor of an account does not benefit from the accountability process. Some seemingly assume that the rendering of an account is a penalty exacted from the conveyor of the account in consequence of the conveyor possessing various privileges and having various responsibilities. Approaches emphasising the immediate interests of shareholders/owners in the accountability process (some of which stress the relevance of legal ownership) and approaches emphasising a broader stakeholder perspective (such as many conceptions of social accountability/accounting) often would appear to share at least this assumption. Adopting the terms common in current conceptions of accountability, such approaches might be understood as perceiving the form and content of accounting publicity as the outcome of a struggle between opposing interests: the agent and the principal (cf. Briloff, 1972, 1986; Bird, 1973; Gjesdal, 1981; Ijiri, 1983; Sherer and Kent, 1983; Roberts and Scapens, 1985; Gaa, 1986; Gray and Jenkins, 1986; Parker, 1986, 1991; Taylor and Turley, 1986; Gray *et al.*, 1987, 1988, 1991; Cooper and Hopper, 1990). Such a perception has received some support from a branch of analytical neo-classical economic reasoning. In the principal/agent literature in information economics (as distinct from that literature on the agency relationship derived from the literature on the economics of property rights) recognition has been given to the problem of a principal who needs, under certain conditions, to incur costs so as to reduce information asymmetries which are seen as operating against the interests of the principal (c.f. Holmstrom, 1979; Christensen, 1982; Baiman and Evans, 1983; Watts and Zimmerman, 1986; Antle and Demski, 1988). The implication here is that disclosure functions for the interests of the principals. Typically, the conveyor either does not gain from disclosure or actually loses (where, in the absence of disclosure, the agent earns economic rents from private information, disclosure can reduce such rents).

Secondly, mainstream conceptions on accountability today which recognise that disclosure functions to the benefit of the conveyor as well as the recipient of information also differ from those of Bentham. Such conceptions, derived from the economics of property rights literature, understand disclosure as the interested act of an informed agent in a markets context. The suggestion is that

[10]His concourse-attraction principle, discussed later, can be considered in similar terms. The same management principles informed both his notions of bookkeeping and publicity, which helps remind us of the managerial-regulatory role of external accounting publicity today. It may be that Bentham also understood publicity to have effects favourable to the more equitable distribution of benefits, given his particular utilitarian position (cf. Dinwiddy, 1989).

the problem of the principal, referred to above, transfers at least in part from the principal to the agent. Agents have an incentive to find a mechanism whereby their principals will continue to support them and thus an incentive to enter into contracts involving their monitoring through accounting which leads to a particular Pareto optimal position. Here it is the case that, again under certain conditions, the interest of the agent is to enter into such a contract (cf. Jensen and Meckling, 1976; Watts and Zimmerman, 1986). These conceptions provide little support for the notion that what functions to the conveyor's benefit, the latter's well-being in Bentham's terms, is the improvement in the conveyor's behaviour in consequence of its exposure. In an explicitly imperfect markets context, other studies point to the sense in which allowing more managerial discretion over publicity can benefit both the organisational conveyor of information and social welfare (if the managerial discretion also permits here the keeping of many activities secret, this being deemed functional for the economic system as a whole) (cf. Laughlin and Puxty, 1981, 1983; Puxty and Laughlin, 1983; see also the literature on information inductance, especially Prakash and Rappaport, 1977).

None of these conceptions appears to capture fully Bentham's particular understanding of the nature of the mutual interest of those involved in the accountability process. His conception of accountability is facilitated by his preparedness both to question tradition and especially to go beyond the emphasis on legal ownership and ownership rights and duties (an emphasis which had also become especially common prior to Bentham's writings; cf. Chatfield, 1977; Haslam, 1991) in favour of a stance deeply concerned to theorise the effects of an accountability process in terms of morality and economy. Central to this stance was the notion that 'surveillance' improved our behaviour in a fuller sense.[11] Bentham felt so strongly about the beneficial effects of accountability that he held it reasonable, at least in some cases, for the state to *require* bodies to publish accounts. For example, he argued that any 'semi-public' company (such as a joint stock company) should be made to disclose accounts and that any dividends declared should be void:

> .. unless accompanied or preceded by a *publication of accounts*, according to a pre-established form, i.e. digested under pre-adjusted heads. These forms might be inserted in the Act of Parliament or the Charter of Incorporation (Bentham, 1797, p. 13)

Bentham thus departed from the laissez faire implications of the market system he advocated. This is not an inconsistency. He preferred central regulation to laissez faire where the former might reasonably be expected to be more conducive to well-being.[12]

The Recipient of Information in the Accountability Process

Bentham held that an array of parties, and ultimately the public in general, would benefit from the prescribing of accountability systems. This can be inferred from his work on pauper management where he wrote that 'the system of book-keeping' was in some cases 'an indispensable security for the due discharge of the several obligations, which the direction of the company .. will have .. to the various parties interested—viz the *paupers* .. the rateable parishioners .. the stock-holders .. government—and the public at large ..' (Bentham, 1797, pp. 99–100).

We can also support this argument here by considering Bentham's usage of the term 'publicity'. This helps to clarify the intended recipient of accounting publicity in Bentham's conception of an effective accountability process. The term publicity is not closely associated with accounting today in the UK (although in some Germanic continental countries the association is still strong, cf. Lowe *et al.*, 1991). The term suggests a disclosure to the public at large, a broader audience than the shareholder group. Although the notion of the public operative in the historical context would still

[11]One might argue that agency theory suggests that the agent's moral and material well-being is enhanced through accountability and that this is very close to Bentham's position. The meaning of morality in agency theory today, however, is very restricted. Morality is in effect equated with doing something other than what is deemed to be in the (narrowly defined) interests of the legal owner. There is a real danger here of reading too much similarity into Bentham's position and that of modern agency theory. One needs to attempt to carefully interpret Bentham's usage of the terms he was working with—such as economy and humanity—in the context within which he was located (cf. Lowenthal, 1985). Our contention is that one can interpret Bentham in such a way as to suggest possibilities and potentialities for today which differ from modern agency theory. There has been quite a history of dismissing Bentham from a variety of politico-philosophical positions (critical and conservative), even if based on a relatively small selection of his diverse notes and texts, which has drawn substantially from a somewhat narrow linking and association of Bentham to subsequent writings on utility and economy (cf. Pitkin, 1990). There is in process something of a reappraisal of Bentham

Footnote continued

which is in part concerned to elaborate the specificity of his work (cf. Lyons, 1973, 1984; Roberts, 1979; Rosen, 1982; Twining, 1989).

[12]Bentham was an advocate of laissez-faire only where he though this most efficacious and, with Adam Smith, was an advocate of state intervention where this could be reasonably shown to be the better option. This was not lost on 'disciples' of Bentham such as Edwin Chadwick and John Stuart Mill. Of course, the laissez faire system in practice is dependent upon a regulatory context, and its historical constitution was preceded by dramatic regulatory interventions (cf. Evans, 1983; Brundage, 1988; Lehman, 1991).

have only included a relatively privileged minority, the term is nevertheless suggestive of broader possibilities, especially in the context of the advocation of an extension in democracy as Habermas, the German philosopher of Critical Theory, has noted (see, for example, Habermas, 1974). Bentham himself became a convert to the democratic movement particularly after his association with James Mill towards the end of the first decade of the nineteenth century (Cumming, 1961; Russell, 1962).

In seeking to collect and make public a wide range of accounting/statistical information focused upon a highly personalised organisational activity, Bentham can thus be considered to go beyond an accountability only to owners. And viewed generously, his concern is as much about the discharge of an accountability to people and to democratic forces. At least, his view suggests the possibility that accounting and accountability might play their part in rendering more effective the functioning of democracy and in enhancing systems of democratic government/management (cf. Butterworth *et al.*, 1989). Notions of accountability, being required to give an account and submit that account to some validation procedure, can be thought of as being integral to modern appreciations of democracy-in-action. But there are many ways in which such accountability might be enhanced, for which Bentham's reasoning is suggestive.

The Unit of Account

A critical questioning of accountability includes, in Bentham, a concern about the very unit of account—just who or what might properly be made to discharge accountability through accounting publicity? In utilitarian terms, Bentham gave some attention to the nature of the body that might be improved on its activities being made visible (to the benefit of more general well-being). Again Bentham's anti-traditionalist questioning might suggest possibilities to be taken up in contemporary debate.

Bentham's writings on administration suggest that he aimed as far as possible at making the individual visible, a principle integral to the Panopticon concept. Consistent with this he sought to associate individuals with given managerial tasks. This 'separate-work' principle had its own principle of publicity—the principle of distinction or the 'separate exhibition principle' (UC, cliiia, 165).[13]

Perhaps reluctantly, Bentham came to accept in some cases, however, the need for group rather than individual management—and became supportive of a 'solidarity' principle (Hume, 1981, pp. 158–63). It is perhaps not surprising that, given his awareness of the significance of 'environmental context' for explaining behaviour, Bentham recognised the difficulty of measuring and assessing individual performance. In his notion of collective solidarity, a managing body, or the group of people constituting an organisation, would be collectively responsible.

It appears useful to be reminded today of possibilities of alternative forms of accounting which go beyond the conventional 'separate entity' unit of account. While this may appear to take us outside the focus of 'corporate accountability', it does remind us that corporate entities might be viewed as collections of individuals reflecting a variety of interests and preferences. Bentham may well, consistent with the above, have been opposed to the de-personalisation that is associated with much financial reporting today, e.g. in 'incorporation', understanding it to be a fiction to assume that a body other than a person or collection of persons can be made accountable in any sense, although he never explicitly appears to have gone that far in his attempts to de-mystify accounts (cf. Goldberg, 1957, on Bentham's attempts to de-mystify the Italian method of double-entry bookkeeping).

Bentham's critique of de-personalised accountability can contribute to thinking on corporate governance today. One might question the extent to which, individually and collectively, people are hidden in the representing of a de-personalised entity. And those critical of modes of directors' remuneration would be expected to support mechanisms whereby rewards might be more openly and clearly linked to director 'performance'. More radically, Bentham's reasoning should lead us to question the relationship between corporate accountability/accounting and publicity more generally. Bentham focuses upon the school, the prison and the factory—but viewed generously he seeks, through this, to benefit the individual people concerned in these entities. Given the broad conception that Bentham had of accounting's potential functioning, it may be more effective to link more directly systems of disclosure and responsibility to the process of democratic government and its administration.

Corporate accountability would find a place within this broader picture. This could be reconciled to a principle of appreciating differences between local units of administration (to which we turn later). For example, the administration of a socio-political system can be broken down into local units for which an individual would be responsible. Such local bodies would be required to disclose details of the broad matters Bentham envisaged, such as the health and ultimately 'well-being' of the individuals within the ambit of their

[13]In this regard, we have already suggested the necessity of bracketing the contemporary distinctions between internal and external accounting in studying Bentham's writings on accountability and accounting.

administration (information might be disaggregated as deemed reasonable). Rewards might be linked to performance in this regard. Companies operating in these localities (e.g. providing employment there) could be subject to an audit by such a local governing body with respect to those local operations (giving rise to a publicity). Bentham was writing in a context where laissez faire was being promoted as a policy actually requiring, through intervention, the construction of an institutional framework. It thus might remind us of barely mentioned assumptions of laissez faire policy today. This may suggest to some a re-thinking of the relationship between corporate, local and central government accounting. For what, where and how we make affairs visible, as well as the substantial content of that visibility, is indicative of the type of community in which we live. These are the issues, at least, which a reading of Bentham can stimulate.

It might be emphasised here that ultimately his scientific reasoning led him to be less concerned about 'blaming or praising' through accounting, and more concerned about the effects or the consequences that the accountability process would have upon the public-at-large. Bentham's accountability is not so much about holding responsible and judging behaviour; nor does it assume a simple agency-principal relation.[14] It should thus be reiterated that Bentham's utilitarian accountability might be understood to be outside conventional understandings of accountability today. It might be thought of as the 'ability to render an account' (account-ability) in the sense that Bentham's accountability appears equivalent to the ability to render accounts conducive to well-being.[15]

The Form and Content of Bentham's Accountability

Bentham, despite advocating prescribed publicity, did not formally discuss practical means of publishing information (for an overview of alternative approaches to publication, see Parker, 1990). Nevertheless he did hint at his position. For Bentham, several desiderata were to be pursued in the aim of ensuring that the discharge of public accountability be proper and effective. Accounts were to be made more uniform, Bentham advocating, for example, uniformity in method in general for all joint stock companies (UC, cliiia, 154, cliib, 282; Bahmueller, 1981, p. 187). Accounts were to be constructed in accord with a 'tabular-statement' (or 'tabular', 'synoptic' or 'bird's-eye-view') principle in which they would be arranged under pre-determined heads, thus facilitating the operation of the management-selection principle.

> The tabular-statement principle is an instrument in the hand of the principle of publicity. It is bookkeeping reduced to quintessence. (UC, cliib, 360n; Bahmueller, 1981, p. 192)

It is of note that Bentham was concerned that accounts be made more uniform, a notion consistent with standardisation. The 'long history' of a standardisation debate evident in the twentieth century is indicated. But Bentham, again interestingly, in the context of the national standardisation of accounting in the UK in the twentieth century, also sought that accounts be not overly uniform, preferring that accounts be modified by a principle of 'local-consideration' (UC, cli, 363–4; Bentham, 1797) and that they be flexible and receptive to change:

> Frame for this purpose at the outset, a set of *blank books* or *forms* to be observed in all, improving them from time to time . . [and a] *local-consideration observing* principle—not to push the principle of uniformity too far. (Bentham, 1797, p. 50; c.f. p. 103)

In parallel, Bentham held that the form and content of the publicity might vary in degree depending upon a body's scale, or other characteristics (c.f. UC, cxxxiii, 61, 62, 65; Bentham, 1797, pp. 180–5, chapter 3, p. 56; Bowring, 1843, viii, 393; Hume, 1970, p. 30, 1981, p. 154). The small firm debate of today, if it might assume a different notion of accounting publicity to that of Bentham, would appear to echo his concerns here to adopt a 'contingent' approach.

Consistent with exposing 'management' widely, Bentham advocated a 'concourse-attraction' principle, whereby, it seems, informed members of the public were to be encouraged to visit accountable bodies and advise them on their managerial practices:

> . . neglect no circumstance that can contribute to engage attention to the management, and attract . . a *concourse* of such visitors, whose remarks may afford instruction, and their scrutiny a spur to improvement, and a check to abuse . . (Bentham, 1797, pp. 56–7)

This may hint today at some sort of fusing of the activities of consultancy and auditing. Accounts

[14]With regard to Bentham's views on agency-principal, Gray (1989) seems right to draw a link between Bentham and modern agency theory. But one needs also to uncover and appreciate the subtleties of Bentham's approach which at least in part is motivated by a deeper concern for everyone in the accountability process.

[15]Bentham's acceptance that it was more important to require some bodies to render accounts than it was to require others, due to their *significance* (elaborated upon later in the text) might also be related to this reasoning. Hence Bentham's view that if 'semi-public' a company should be subject to publicity (UC, cliiia, 154; cliib, 282; Bahmueller, 1981, p. 187). Bentham's projects also included the promoting of limited liability in this regard, limited liability companies being required to meet criteria of accountability (cf. Polanyi, 1945, p. 124).

were also to better represent 'facts', including economic facts. Thus attention was directed to 'real' as well as to monetary transactions, it being recognised that in some cases value derived from monetary transactions could not represent the worth of a concern (c.f. UC, cxxxiii, 65; Hume, 1970, pp. 25–6; 1981, p. 152). Bentham thus points to the 'long history' of concerns, which have influenced twentieth century accounting theory and practice, to *better* 'represent' the 'economic' position and progress of the micro-enterprise (allowing for comparability), an insight consistent with Chambers and Wolnizer's (1991) view that a 'true and fair' view once implied a representation of economic value. Such points are useful reminders and reinforcements in contemporary debate.

While he in effect narrowed accounting's possibilities, in suggesting that accounts be tabulations of 'facts' rather than 'mere opinions' and be preferably expressed in numerical terms (cf. Bahmueller, 1981; Hume, 1981),[16] Bentham, as can again be inferred from his texts on pauper management, had a very broad understanding of the nature of bookkeeping facts. Accounts were to make visible, for example, not just the economic but the moral. Bentham advocated 'moral bookkeeping', again echoing 'serious Christianity' (cf. Davidoff and Hall, 1987), a position not dissimilar from that taken by Robert Owen in his New Lanark factory (a project in which Bentham was a sleeping partner) (cf. Walsh and Stewart, 1988). Understanding financial accounts to be conventional, Bentham sought to extend such accounting 'in its limits', to 'rationalise' it and thus go beyond, if to include, a focus upon the financial (Bentham's bookkeeping-at-large, cf. Bentham, 1816, notes to tables; cf. Bahmueller, 1981, p. 193). Thus accounts might play their part in the management of the 'health' and 'comfort' of people (cf. British Museum Manuscript MS 33541, f. 203, note drafted by Bentham, 23rd January, 1791; Bowring, 1843, vol. viii, pp. 392–3; cf. Bahmueller, 1981, p. 192). Bentham's approach challenges a focus upon an entity's narrow financial calculus.

When Bentham's democratic concerns and his concern to account to a variety of 'interest groups', including the public-at-large, are associated with Bentham's broader perception of accounting (accounting-at-large: cf. Bentham, 1816, notes to tables), a phenomenon 'extended in its limits', we begin to perceive another 'long history': that of calls for a disclosure that would not 'simply' concentrate on the 'financial', a disclosure that would inform a democratic process (at least as much concerned with 'humanity' as 'economy')—the long history of what is most often referred to today as social accounting. That 'accounts' were not always restricted to 'financial' matters by Bentham (and indeed many others in the historical context, c.f. British Parliamentary Papers, 1825 (522), IV, 321; 1826–7 (558), III, 869; Davidoff and Hall, 1987; Haslam, 1991), needs to be appreciated since it is perhaps generally assumed that broader, 'non-financial', visions of accounts are relatively recent—the same point can indeed be made with regard to views of accountability adopting a stakeholder rather than shareholder approach (cf. Sherer and Kent, 1983; Neimark, 1986; Parker, 1986; Gray *et al.*, 1987, 1988, 1991; Cooper and Hopper, 1990; cf. also Puxty, 1986, 1991; Haslam, 1991; Parker, 1991).[17]

History can once more reinforce contemporary concerns. And the changing conceptions of accounting suggested in our study might allow us to declare that many *alternative accountings* are just as much *accounting* as that which today is taken to be the conventional variety. In corporate accountability one is concerned to 'manage' the management. Perhaps it is worth emphasising here that Bentham understood the greatest benefits to follow from the most open disclosure of management affairs. This may seem naive today when a very different view is often expressed by management and policy-makers. Bentham's perspective, as already discussed, reflects his particular perception of a mutual interest between the conveyor and the recipient in the accountability process. One wonders whether or not Bentham would have explicitly modified his views had he lived a little longer, especially in the context of concerns to enhance capitalistic growth through a more laissez faire market system, which gathered pace in the 1830s. These concerns explicitly appreciated, in this regard, the potentially restrictive effects of extensive disclosure (see, for example, British Parliamentary Papers, 1836 (591), IX, 411; Haslam, 1991).[18]

[16]The trajectory that accounting was following may be taken to have its parallel in the history of statistics. Statistics narrowed in conception from 'knowledge of the state' to collections of numerical facts. Bentham, who sought to establish a statistical society, in effect equated accounting with statistics in this regard (cf. Cullen, 1975; Burchell *et al.*, 1980).

[17]Others have noted that legislation of the nineteenth century prescribing accounting was not mainly for the benefit of owners (e.g. Parker, 1990; cf. debates over such legislation—see, for example, Edwards, 1986, 1989; Haslam, 1991).

[18]It may be objected that Bentham's broad conception of publicity and its content applied only to the 'management of paupers'. If this were the case it would not negate reading Bentham as suggesting possibilities and potentialities for today—we are not here advocating Bentham *in toto*, rather we are concerned to gain insights into such potentialities and possibilities. Nevertheless, the argument can be made that Bentham had a broad conception of publicity for the more general case. Arthur Young, who influenced his position in his work on pauper management, was concerned with accounting and bookkeeping more generally (cf. UC, cliiia, 154a, 33). And serious Christianity and moral book-keeping were not restricted to 'pauper management' (cf. Davidoff and Hall, 1987; Walsh and

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As well as aiming to render further dimensions of activity more visible and open, Bentham sought to make accounting/publicity, the instrument of accountability, also more accountable, open and comprehensible to the non-expert. Bookkeeping/publicity, with statistics, had to be 'inspective or information-elicitative': 'natural' were to replace 'technical' expressions, the latter potentially even being an instrument of fraud rather than protection from it (Bowring, 1843, ix, pp. 219–26: Goldberg, 1957; Hume, 1981, p. 51). In Bentham, the desire for an 'accountable accounting' was linked to the conception of accounts as an instrument of (beneficial) control: the wider the audience, for whom accounting language might be made more accessible, the more effective the accountability process and the publicity principle in securing the 'duties'—this implying a strong faith in public opinion (cf. Gallhofer and Haslam, 1991):

> The more universally the particulars of the management are held up to view, the more universally the means of observing, and thence of adopting, whatever is good, and of observing, and thence of avoiding, whatever is bad . . and the stronger the force (because the greater the *certainty*) with which the motives derivable from the *popular* or *moral*, as well as those derivable from the *political* or *legal* sanction operate towards the insuring such adoption and avoidance.

In effect, at least in this respect, Bentham recognised that accounting itself was not a neutral or straightforward device: rather accounting-in-practice was often, in his view, an overly 'technical and mystifying' mechanism. Accounts had to be 'corrected in their language'. Perhaps it is ironic that his stress on the benefits of numerical and tabulated statements arguably contributed to accounting's failure properly to admit to its inevitably non-neutral, socially-laden nature.

Conclusion: the Benthamite challenge

In sum, Bentham appears to offer a radical challenge to contemporary perspectives on corporate accountability today. In our view several aspects of this challenge may be of significance to debate in reinforcing contemporary criticisms of corporate accountability, in indicating the historical dimension of such criticisms and in offering new insights. Firstly, there is the point that Bentham rigorously adopted an anti-traditionalist stance. Traditions could not be accepted on the grounds only that they were traditions. A perspective rooted in legal ownership and notions of ownership rights and obligations, for example, was displaced in favour of a concern that accountability be assessed in terms of its wide-ranging socio-behavioural effects (in terms of 'humanity' and 'economy'). This carries quite a radical implication for contemporary debate which has been informed greatly by a theory of property rights. Bentham seems to imply that we should look beyond accountability to the consequences of a required disclosure for the community of interests involved—in representing, Bentham seeks, quite openly, to intervene: what is desirable here is not accountability as such but the pragmatic ability to regulate accounts for beneficial consequences. While the latter notion intersects with the former it also goes beyond it.

Next, the particular sense in which Bentham emphasises that the conveyor of information can benefit from the accountability process might be worthy of further exploration. Accounting policy-making can more explicitly be re-thought in terms of its effect on the interested parties in the accounting process. The notion of accounting to the public at large, which has a substantial history, needs to be taken seriously. Next, the concern that accounts be mobilised for duties other than the strictly economic might be taken up further. Accounts can be conceived of as reinforcing the morality of the accounted for; potentially with deeply beneficial consequences. Indeed it is surely of some substance that Bentham, writing in a context significant for the development of modern accounting (cf. Edwards, 1989; Haslam, 1991), understood accounting's role to be more moral than economic. Relatedly, that accounts be understood as informing a democratic process whereby the citizen or public at large is the receiver of the information in the accountability process, might be a notion worth further developing. Accounting can be an implement of democratic accountability and control.

Next, and again relatedly, debate needs to question the very unit of account that is taken for granted as the body deemed accountable in most contemporary discussion. Next, the form and content of accountability might be questioned through all the Benthamite insights, general and particular. In this regard, apart from Bentham's concern with real as opposed to monetary transactions and his support of a principle of uniformity, Bentham's local-consideration principle, concourse-attraction

Footnote continued

Stewart, 1988; see also Polanyi, 1945, p. 11). His view that the role of publicity is more moral than economic is written as a general principle (Bentham, 1797, pp. 51–2). His texts on education and the classification of disciplines, which are intended to be very general, link accounting publicity to statistics and adopt and advocate a broad understanding of accounting publicity (c.f. Bentham, 1816, 1817). And, as Foucault (1979) has appreciated, Bentham was concerned to stress the similarity of administrative organisations whether they be schools, prisons or factories (see the letter to the Right Hon. John Parnell, Buxton, Derbyshire from Bentham, British Museum Manuscript, 2 Sep. 1790, MS 33541, f. 160). Hume (1981, p. 157) suggests that Bentham is concerned to apply general principles to all complex organisations.

principle and his promotion of a non-financial accounting should stimulate debate (including at the interface of auditing and consultancy). Finally, following Bentham, the accountability of accounting itself might also be explored. An implication is that, consistent with a concern to promote democratic openness, the accounting profession might critically examine whether its own deliberations on accounting and accountability are as 'true and fair' as they could be. A concern to be less mystifying if not overly simplifying should be a governing principle of the accountant—as professional and expert—as well as the accounts.

Bentham's texts may thus be construed as having implications for accountability and the rendering of an account. In critically questioning the form and content of the information flow, in pondering upon who should actually render an account, and why, Bentham offers insights into the debate on corporate accountability, including in the sense of suggesting possibilities or potentialities for accountability and accounting today. History may thus provide us with fresh eyes. A new impetus can be gained for inquiring about what we want from accounting. This can provide us with a deeper, more informed, approach to the challenges, currently evident, of arriving at and meeting criteria for accountability and corporate accountability today.[19]

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[19]The reading of Bentham we elaborate appears to extend or go beyond the proposals of the Cadbury Committee on corporate governance, in several respects. In this regard, it would have implications for a 'code of best practice' and extensions to company reporting and auditing (including to assess the effectiveness of control systems). In particular it would go beyond 'the financial aspects' of corporate governance. We understand our reading of Bentham to contribute to the general contemporary debate on corporate governance. Although we have not explicitly done so here, it is also possible to find much in Bentham's analysis of social artefacts, including accounting, to be critical of (cf. Bahmueller, 1981; Gallhofer and Haslam, 1992). Here we have tried to present Bentham's writings on accountability in more positive terms, as suggestive of possibilities and as a contribution in this sense to contemporary debates. In this paper neither have we considered the parallel between Bentham's reasoning on corporate accountability and the conceptions of corporate accountability held within the nineteenth century state. While this might clarify the views held by Bentham by attempting to gauge their reception (favourable and unfavourable), it would detract from the central purpose of this paper. Haslam (1991) evidences apparent parallels in analysing debates over the regulation of friendly societies, banking and joint stock companies (see also Parker, 1980; Edwards, 1986, 1989). Haslam (1991) and Gallhofer and Haslam (1992) also point to the more direct influence of Bentham upon the British state, and provide clues as to the reasons why Bentham's views have been less than fully taken up.

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Managerial Remuneration and Corporate Governance: A Review of the Issues, Evidence and Cadbury Committee Proposals

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Abstract—This paper examines the UK system of corporate governance, the remuneration of senior executives and the Cadbury Committee's proposals for increasing managerial accountability to shareholders. We argue that the UK governance system does not provide shareholders with incentives to seek 'voice' solutions to problems of corporate governance and that the Cadbury proposals, which rely on market-based regulation, will do little to alter this. The design and monitoring of executive remuneration schemes is costly and, because of lack of transparency, it is unclear that these performance related schemes are necessarily in shareholders' interests. The empirical evidence relating to the role of non-executive directors and remuneration committees, as advocated by the Cadbury report, also suggests that this process is largely under the control of the executive directors themselves.

Introduction

In this paper we examine some of the main issues and empirical evidence relating to corporate governance and managerial remuneration. The central issue of corporate governance is how to ensure accountability of senior managers to their shareholders and other stakeholders whilst still providing executives with the autonomy and incentives to exploit wealth producing strategies.[1] Though a perfect institutional solution to this problem is probably unattainable, governance systems differ in their ability to attenuate opportunism and ensure some measure of accountability. The current UK system, because it does not require either a supervisory tier (as in Germany) or even outside (non-executive) directors on the boards of companies (as in the US), suffers from a lack of 'transparency' and relies heavily upon the exercise of self-discipline by executive directors. This is nowhere more apparent than in the setting of senior executives' remuneration. Executive remuneration schemes increasingly include large 'performance related' bonuses and stock option provisions, and their adoption and administration are invariably under the control of the executives themselves without reference to shareholders.

The recent (and widely reported) concerns in the UK regarding the setting of senior executives' remuneration have been perceived as 'the visible signs of a governance system that was not serving companies or their shareholders as well as it should' (Cadbury, 1992). In principle, the introduction of remuneration schemes which make a significant proportion of managers' pay dependent upon shareholder wealth increases could be an important mechanism by which manager and shareholder interests are better aligned (for reviews, see Murphy, 1986; Rosen, 1990). However, the lack of transparency in respect of these often highly complex remuneration schemes renders it impossible for shareholders to judge whether they are in their interests.

The Cadbury report contains several proposals for improving accountability in this area, including a greater role for non-executive directors and remuneration committees in the setting of senior executive pay. We examine these proposals later in the paper. Here, we merely note that the impact of these proposals will depend crucially upon their ability to improve shareholders' incentives actively to monitor and control senior executives' actions; that is, to seek 'voice' rather than 'exit' (i.e. selling

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[1]Though in this paper we focus exclusively upon shareholders and management, we recognise that there are other stakeholders whose interests may be materially affected by managerial decisions and inadequacies in corporate governance. Thus, value gains accruing to either or both shareholders and management may be at the expense of other stakeholders and, therefore, cannot necessarily be viewed as 'efficient' or as a net social gain—this is a fairly obvious point, but one which is frequently overlooked in capital market studies.

shares) solutions to problems of accountability.[2] We argue below that the UK (and US) corporate governance system does not encourage 'voice' and the Cadbury proposals, because they rely exclusively upon existing, market-based self-regulation, are unlikely to alter this materially.

The UK system of corporate governance

Formally, the UK's system of corporate governance provides for a chain of accountability whereby executives are accountable to the board of directors, who are in turn accountable to the shareholders. However, in practice the distinction between managers (accountable to the board) and directors (accountable to the shareholders) is less than obvious because the boards of most large publicly quoted firms are dominated by executive directors. A recent study by Cosh and Hughes (1987) indicated that for the 'typical' large UK firm, executive directors outnumbered non-executives by approximately two to one and that the majority of non-executive directors were either retired executive directors of the firm or executive directors in other large firms.[3]

Apart from the right to sell their shares, shareholders' formal powers are largely limited to electing and re-electing the board at the annual general meeting (AGM). Moreover, unless the firm is performing particularly badly, the AGM is normally a perfunctory affair and it is rare indeed for the board to be seriously questioned regarding corporate strategy or pressured by shareholders into changes of policy or personnel.[4] As Charkham (1989) has noted:

> Even with proxies, the total of votes cast in the United Kingdom is often no more than 12% to 13% (unlike in Japan), which makes it clear that even institutional shareholders seldom vote. (p. 7)

The real problem we would argue is not the lack of formal powers of the shareholders, but rather the lack of incentives to act due to the 'public good' characteristics (joint supply and non-excludability) of monitoring and control activities. It is costly to become informed as to whether an apparently poorly performing firm is due to poor management or to other factors and to evaluate the relative merits of alternative management teams. Hence, each shareholder has an incentive to free ride and it becomes irrational for shareholders to devote resources to becoming better informed and voting intelligently. Thus, in the absence of collective provision, there may be insufficient resources devoted to managerial monitoring (see Grossman and Hart, 1980; Stiglitz, 1985). Even shareholders with relatively large holdings, such as institutional investors that do monitor managerial performance, rarely find it worthwhile to intervene because the existence of active secondary markets and the difficulties of intervention normally provide them with the less costly option of simply exiting (selling their shares). In consequence, there is an absence of committed owners that find it to be in their interests to monitor and control managerial actions.

External (market) control mechanisms, such as the threat of takeover (Jensen, 1986 and 1989), debtholder actions (Grossman and Hart, 1982), the managerial labour market (Fama, 1980) and City analysts, have all been suggested as alternative market-based constraints upon managerial opportunism. The efficacy of these mechanisms is, however, somewhat limited. Debtholders can only intervene when the security of their investment is seriously at risk and therefore only very poorly performing firms are likely to be subject to this control mechanism.[5] Financial analysts usually rely heavily upon management for information and, therefore, will be particularly wary of voicing criticisms that might sour relations. Indeed, as the events surrounding the recent publication by Smith (1992) indicate, such criticisms (in this instance, the public discussion of the dubious accounting practices of client firms) may lead to disciplinary consequences if a client firm complains to the analyst's employer.

The market for corporate control, whilst successful in some instances in removing poor managers, seems just as likely to lead to the removal of good managers. Indeed, the possibility of takeover further reduces shareholders' incentives to monitor managers. This is because control of a firm is of value to a bidder and, therefore, the takeover threat provides current shareholders with the possibility of realising a bid premium irrespective of whether or not the bidder will actually improve firm performance. Furthermore, much managerial time and many resources are consumed in devising strategies which, though they may reduce the threat of takeover (e.g. financial reporting manipulations, golden parachutes, poison pill provisions), often do so in ways that do not seem to be in share-

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[2]The Exit-Voice trade-off model was first developed by Hirschman (1970) and has subsequently been applied to the study of public choice issues (Mueller, 1979), internal labour markets (Freeman and Medoff, 1984; Wilson and Peel, 1990) and corporate governance (Charkham, 1989).

[3]Cosh and Hughes' study also indicated that most of the remaining non-executive directors were either politicians or retired civil servants, neither of which were normally significant residual claimants (shareholders).

[4]Evidence from the US (see Morck *et al.*, 1989) suggests that even when a firm under-performs its industry stock average by 75% for two consecutive years, there is only a 5% probability of the senior executives being removed from the board.

[5]Obviously, the more concentrated the debt structure and the more highly geared the firm, the greater the incentives of debtholders to intervene and to do so relatively early to prevent additional value losses.

holders' interests.[6] As Charkham (1989) has noted, takeovers, as a means of removing incompetent managers, 'are expensive and founded in a monstrous illogicality—that a change of ownership is necessary in order to change management'.

The Cadbury proposals

The Cadbury Committee proposals to improve corporate governance rely exclusively upon continued self-regulation, a (voluntary) code of best practice, improved information and a strengthening of the independence of auditors.[7] The proposals for fuller disclosure of financial information and greater independence and clarity regarding the firm's relations with auditors will undoubtedly improve the information available to shareholders. However, neither the ability of nor incentives to auditors to highlight problems of corporate strategy and governance, at an early enough stage for something to be done about it, are likely to be materially improved by these proposals. Similarly, even if shareholders are armed with better information, the lack of incentives for them to use 'voice' rather than exit solutions remains unchanged.

The Code of Best Practice also contained a number of proposals to provide greater accountability in respect of the setting of senior executives' remuneration. The requirements of most relevance to the issue of remuneration include:

—All quoted companies should have at least 3 non-executive directors, directors' service contracts should not exceed three years without shareholders' approval and the posts of CEO and chairman of the board should not be held by the same individual.

—The total emoluments of directors and those of the chairman and the highest paid UK director should be fully disclosed and split into their salary and performance related components and the basis by which the latter is determined should also be explained.

—Executive directors' remuneration should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.

As we shall discuss in the following section, there are a number of conceptual and practical difficulties in designing and monitoring an appropriate executive performance related remuneration package. The efficacy of the Cadbury proposals for a greater role for non-executive directors in the setting and monitoring of executive remuneration will, therefore, depend crucially upon how these non-executive directors are selected, what powers and resources are made available to them and how independent they are *vis-à-vis* the executive directors. Some empirical evidence on these issues will be discussed after the next section.

Managerial remuneration and accountability

Performance Related Pay (PRP): Theory and Practice

From an agency theory perspective, the rationale for introducing PRP for senior executives is to create a commonality of interest between the shareholders (principals) and the executives (agents).[8] If managers are assumed to need (and respond to) financial incentives to act in shareholder interests, then shareholders can gain by introducing an appropriately structured PRP scheme which rewards senior executives with a share in any increased wealth generated. PRP schemes can, therefore, not only reduce the costs associated with managerial non-performance, but can also reduce the need for direct monitoring of executives (see Murphy, 1986).

In order to have these beneficial consequences it has to be assumed that shareholders actually have the opportunities and incentives to design, implement and monitor appropriately structured executive remuneration packages. If, however, these processes are largely under the control of the executives themselves then, because it is assumed that executives are self-interested agents, it follows that only incentive contracts that serve these interests will actually be implemented by executives. Thus, any lack of transparency in respect of the implementation of PRP schemes can be exploited by executives. Indeed, in some situations, it may be

[6]Lambert and Larcker's (1985) results showed that the market responded favourably to the introduction of schemes which gave large severance payments (golden parachutes) to executives who lost their jobs subsequent to a merger or takeover. This, however, does not imply that these schemes are in shareholders' interests. They may simply be acting as a signal to the market that the firms' managers have received private information that the shares are undervalued and/or that a bid (and hence a bid premium to current shareholders) has become more probable.

[7]Though the Cadbury proposals do not go beyond current US and UK best practice, both the Confederation of British Industry (CBI) and the Institute of Directors (IoD) in their submissions on the draft report published in May 1992, objected to the increased 'policing' role of non-executive directors. Moreover, the IoD was highly critical of any shareholder and auditor involvement in corporate governance, whilst the CBI saw the proposals as 'the first step towards "two-tier" boards' and was 'worried about the proposed Code of Best Practice becoming a Stock Exchange listing requirement'. The final report took account of these objections since it explicitly supports the UK's current unitary board system, reduces the earlier emphasis on the 'policing' role of non-executives and does not require companies to conform to the code in order to retain their market listing.

[8]With a competitive external labour market, Fama (1980) suggests that PRP will also be important in order to retain managers.

difficult for the principal to specify a quantitative target or satisfactorily monitor performance because of the agent's informational advantage (see Baker, 1992). Moreover, the inability directly to observe the marginal product of executives and the difficulty in reliably measuring the elasticity of PRP incentives with respect to increases in shareholder wealth further reduce transparency. In practice, therefore, shareholders cannot be confident that PRP schemes operate in their best interests or that more preferable and feasible alternatives do not exist. Hence, PRP, rather than being a substitute for shareholder monitoring and control, creates a whole new set of accountability problems. Less than adequate monitoring and the unobservability of (shareholder) preferred alternatives not undertaken means that interpretation of the empirical evidence which relates pay to performance will necessarily be ambiguous.

For example, the findings of a recent UK study into the actual operation of executive share option schemes (Cranna and Samuels, 1992) suggests that, because of widespread practices such as discounting, voluntary lapsing, preemption and a lack of adequate disclosure of information, executives were frequently able to increase their remuneration even when company profits and share prices were falling. The paper by Egginton *et al.* (1993, this issue) also illustrates this lack of transparency in respect of the operation and monitoring of executive share option schemes. Using a comparative analysis of the post-tax cost of executive share options, Egginton *et al.* show that, though the purchase of existing shares is actually cheaper and the statutory disclosure requirements more easily understood, a high proportion of firms still elected to issue new shares to their executives.

The above studies indicate that managers do not always have shareholder interests uppermost in mind when considering their own remuneration. Even so, a number of US empirical studies have found that the market reaction to the announcement of many executive incentive schemes has been favourable (Tehranian and Waegelein, 1985; Brickley *et al.*, 1985; and Kumar and Sopariwala, 1992). This, however, does not necessarily imply that managers are acting solely in shareholder interests. It still remains the case that there may be other feasible incentive contracts which could further increase shareholder value but which were not implemented simply because they were less preferred by executives.[9]

Determinants of Managerial Remuneration

A further difficulty in interpreting the empirical evidence is that, in practice, a host of human capital (Becker, 1964; Spence, 1974; Ingham and Thompson, 1993, this issue), firm specific (particularly, size and industry) and external labour market factors (Fama, 1980) besides firm performance are relevant to the determination of executive pay.[10] As the large labour economics literature (reviewed in Creedy and Whitfield, 1989 and Wachter and Wright, 1990) concerning the workings of the internal labour market suggest, pay is largely determined not by increments for better performance, but by promotion via internal career structures and competitive tournaments. Murphy (1986) for example reports that vice-presidents receive an average rise of 18% in a move to a senior post, compared to an average yearly increment of 3.3% if they remain in the same post.[11] Such career concerns suggest an alternative maximand for rational self-interested managers, namely, maximising the total of implicit career concern incentives and the explicit performance related pay incentives. Gibbons and Murphy (1992) attempted to test this hypothesis empirically by examining the relative degree of sensitivity of pay to performance for successive age cohorts of CEOs. They found that CEOs in their final three years of office (for whom career concerns will be minimal) had remuneration packages which contained the closest relationship to (stock price) performance of all the age cohorts.

Not surprisingly, a primary determinant of senior managers' remuneration is company size (Benson, 1985; Blandy, 1982; Blandy and Richardson, 1982; Cosh, 1975; Jensen and Murphy, 1990), a typical figure in the literature being that a 10% growth in the size of a company is associated with a 3% increase in the management team's salary (Baker, Jensen and Murphy, 1988, p. 609). Similar findings of a significant positive relationship between changes in executive remuneration with changes in firm size, but not with firm performance measures (shareholder returns and accounting earnings), were also reported by a recent UK study (Gregg, *et al.* 1993). Hence, while PRP may have a crucial role as a source of incentives, we should not expect it to be the major determinant of executive pay. Indeed, Jensen and Murphy (1990) showed that the elasticity of managerial remuneration to shareholder wealth was typically very low.

[9]In agency theory terms, the incentive contracts actually observed are likely to represent 'third-best' solutions to the agency problem.

[10]Bartlett *et al.* (1992) invoke the theory (first suggested by Smith, 1776) of 'compensating differentials', whereby executives are paid extra for suffering undesirable aspects of a job, to justify their inclusion of various firm specific factors into the wage equation. Stiglitz (1987) makes the case that, in the absence of other incentive mechanisms, in order for a firm to attract and retain employees of 'high quality' and to discourage cheating, it will be efficient to pay them a wage that is greater than the current market rate.

[11]These observations are also consistent with the 'tournament' model of Lazear and Rosen (1981) whereby the top jobs are viewed as a 'prize' and involve a large increment in pay in order to motivate lower level managers to participate.

They estimated that the median CEO experiences a $3.2 increment in remuneration for every $1000 of shareholder wealth created. For the smallest firms, this estimate rises to $8.5 which, according to the authors, still falls far short of a compelling incentive. Moreover, as the amount of executive wealth invested in their own company's stock falls so does the elasticity of managerial income with respect to shareholder wealth.

Finally, a number of recent studies have examined the influence of governance structures, such as the ownership form, the CEO-Board relationship, the presence of non-executive directors and remuneration committees, upon the level and composition of executive pay. For instance, Mangel and Singh (1993, this issue) show that, though the proportion of non-executive directors, the level of non-executive directors' fees or a shareholder with a 5% or more holding are not significant determinants of executive remuneration levels, the presence of institutional investors on the board and CEO tenure do have significant negative and positive influences respectively upon remuneration levels. Ingham and Thompson (1993, this issue) show that for the UK 'mutual' building societies, executive pay is only weakly related to firm performance measures (profitability). Of far greater importance were changes in the competitive and regulatory environment, human capital (age, experience and educational achievements) and firm size attributes.

Share Price Performance Measures

Increasing the intensity of incentives via a greater use of PRP, however, assumes that there is a relatively well defined causal relationship between executive actions and the performance measure used. Simply basing a greater proportion of executive pay upon increases in shareholder wealth is not without its problems because a large number of uncontrollable random events that do not provide reliable feedback on executive performance (i.e. 'noise') affect share prices. If stock prices respond solely to what is disclosed regarding discounted cash flows (dividends and capital gains) then managers rewarded on the basis of stock prices will have their remuneration determined by events that resolve uncertainty about discounted cash flows even though these events may reveal little about their own efforts and ability. If managers' pay is too closely related to a performance measure that does not reliably reward skill and effort (i.e. share prices) then managers may become demoralised and/or may be motivated to take actions which are not in shareholder interests but which circumvent their exposure to uncertainty. As Lambert and Larcker (1987) argue, the optimal compensation policy should be constructed with reference to the performance metric displaying the highest 'signal to noise' ratio regarding managerial inputs.[12] Clearly, stock prices are based on the 'noisiest' signals simply because these resolve the most uncertainty and, hence, they will often not provide a suitable performance measure for determining a large element of managerial remuneration (see Paul, 1992).[13]

Accounting Based Performance Measures

Accounting based performance measures, such as a mechanical formula based upon earnings per share or return on assets, reduce the uncertainties over how performance is to be evaluated. Nevertheless, it appears to be extremely difficult to produce a mechanistic formula that does not encourage some form of dysfunctional behaviour since such formulae often give executives incentives to manipulate the metric against which they are judged (Healy, 1985). For instance, executives may be motivated to take actions which result in an increase in reported profits, such as reducing R&D, product quality or plant maintenance, but which may result in a decrease in firm value (Dechow and Sloane, 1991). With a larger proportion of executive pay becoming dependent upon accounting based performance measures, the incentives for executives to engage in such dysfunctional behaviour are likely to be intensified. Glinch (1991) presented empirical evidence for US firms which suggested that the design of a significant number of remuneration packages incorporated measures which mitigated some of the most glaring dangers in this regard. Even so, in order for (even 'optimally designed') incentive contracts to produce the desired effects in terms of shareholder wealth, additional costs will have to be incurred in monitoring the operation of the contract, particularly the calculation of the accounting performance measures used. Of course, if shareholders were willing to incur such monitoring costs, there would possibly be less need for such a great reliance upon PRP in the first place.

Non-executive directors and remuneration committees

In order for non-executive directors to monitor and control executives they need to be indepen-

[12]The concept of 'noise' in relation to managerial performance measures refers to those aspects that do not provide reliable feedback on executive efforts. Clearly, this concept cannot be equated with the statistical concept of 'noise' as the unexplained variance about a regression plane. For instance, abnormal returns may be the one aspect of share prices that does provide reliable feedback (i.e. the non-noisy component) whereas in any empirical estimate of risk-adjusted returns, abnormal returns are represented by the unexplained residuals (i.e. statistical noise).

[13]While Paul (1992) argues that the market focuses on the most volatile projects in a firm's portfolio in setting the share price, it is also the case that part of managers' skill is the choice of projects that together constitute the firm.

dent. However, Milgrom and Roberts (1992) have summarised the US evidence regarding the relationships between executive and non-executive directors as follows:

> [non-executive directors] are effectively nominated by the CEO, they must rely on the executives for most of the information they receive, and they need good relationships with the officers if they are to function well in guiding corporate policy. Often, directors share similar backgrounds and interests with the firms' executives. Frequently, they themselves are senior executives in other firms. Moreover, outside directors who are not CEOs of other firms may well derive a significant portion of their incomes from their directorships. (p. 434)

Jensen (1989) has been even more pointed, suggesting that the notion that:

> outside directors with little or no equity stake in the company could effectively monitor and discipline the managers who selected them has proven hollow at best.

For the UK, both the Cosh and Hughes (1987) study of board membership and a study on remuneration committee membership by Main and Johnston (1992) suggest that the level of independence of non-executive directors may also be very limited indeed. However, a US study by Byrd and Hickman (1992) into the effects on tender offer bids indicated that, in this context at least, shareholders appear to gain from more effective monitoring by independent outside directors, but that these gains may be subject to diminishing returns as the proportion of outside directors on the board went above 60%.

Evidence from both the UK and US (where remuneration committees are almost universal) strongly suggests that, not only do outside directors typically have close ties with the executive directors they are meant to be monitoring, but that they are also no less likely to award large pay rises which bear little relation to company performance. Studies by Main (1991), Main and Johnston (1993, this issue) and O'Reilly *et al.* (1988) indicate the 'strong social influence considerations' that affect the pay awards granted by remuneration committees. These studies suggest that the remuneration received by non-executive directors in their own companies largely conditions (or, to use Tversky and Kahneman's (1974) terminology, 'frames') what is deemed to be a 'reasonable' pay award when serving on the remuneration committee of other companies.

A recent UK study by Main and Johnston (1991) of 220 large listed firms, 63 of which had remuneration committees, indicated that, even after controlling for differences in firm size and performance, the level of pay awarded to chief executives when the firm had a remuneration committee was significantly higher (£36,000 to £46,000 per annum) than for firms without such committees.[14] The revised estimates presented by Main and Johnston (1993, this issue) suggest that on average remuneration committees award an additional 17% to 21%, or some £56,000 per annum, to their CEOs. However, as the authors point out, the main purpose of a remuneration committee is not to hold down, or for that matter to increase, pay levels, but rather to tie pay more closely to company performance. In this respect then Main and Johnston's results regarding the breakdown between pay in cash and pay in the form of stock options, which showed that 'there was no discernible effect that could be attributed to the existence of a remuneration committee', indicates that there is little evidence that the current remuneration committees in the UK are having the desired effect.

Clearly, if the Cadbury Committee proposals regarding the greater roles of non-executive directors and remuneration committees are to be realised, then a more fundamental reform of the process of nomination and appointment of non-executive directors will need to be instituted. In the absence of such reforms and/or other institutional changes which encourage greater shareholder use of 'voice' mechanisms, the remuneration committee is likely to be little more than a legitimating device whereby senior executives continue to set their own pay without any more accountability to shareholders. We believe, therefore, that the Cadbury proposals are unlikely to have much impact upon either the setting of managerial remuneration or the central problem of corporate governance: how to improve the ability and incentives of shareholders to motivate, monitor, control and, if necessary, remove incompetent management.

Concluding remarks

This paper has examined the relationship between managerial remuneration and corporate governance. The lack of shareholder incentives to monitor managers provides the latter with opportunities to take actions which are not in the interests of the former. In consequence, senior managers dominate the boards of most large UK

[14] The suspicion that a 'cosy collusion' exists between executive and non-executive directors, who sit on each other's remuneration committees and thereby bid up executive earnings, appears to be relatively common. For instance, Tatton (1992) of Incomes Data Services (a major managerial remuneration consultancy firm), was recently quoted as saying that: 'Remuneration Committees don't control pay at all, because they are effectively setting their own pay levels. They talk each other up'.

firms and generally have the power to design and implement their own remuneration schemes.

This lack of direct monitoring by shareholders has frequently been used as both an explanation and justification of the great reliance upon PRP schemes for senior executives. PRP schemes, whilst they may often have the potential to make managers' pay more responsive to firm performance, do not necessarily imply that such schemes are in the interests of shareholders, particularly since there is little evidence that firm performance is significantly improved or that the other components of pay have been significantly reduced. Moreover, PRP may induce managers to take actions which, though they may increase the current earnings of managers, may not be conducive to shareholder interests. If they are to be effective mechanisms for aligning shareholder and manager interests, shareholders will need continually to monitor the operation and appropriateness of such schemes. Hence, executive PRP schemes cannot be seen as an adequate substitute for shareholder monitoring.

The Cadbury Committee's proposals to give a greater role to non-executive directors in the setting of executive remuneration have also been discussed. The empirical evidence from both the US and the UK regarding the influence of non-executive directors and the operation of remuneration committees in the setting of executive pay, does not suggest that, to date, these institutional innovations have significantly improved executives' accountability to shareholders. This appears to be because the appointment and remuneration of non-executive directors are controlled by the executives themselves. Hence, since shareholders cannot rely upon the self-discipline of executives, radical changes in the process whereby non-executive directors are appointed will be needed to bring about the more effective monitors envisioned by the Cadbury Report. This is likely to require a more active involvement in the appointment process by institutional shareholders. However, for shareholders to be willing to undertake such roles, other institutional changes may be necessary which significantly shift the incentives towards the use of voice rather than exit mechanisms. Unfortunately, the Cadbury Report does not have anything to say on this matter beyond exhortations to institutional shareholders to undertake a more active role in corporate governance.

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Ownership Structure, Board Relationships and CEO Compensation in Large US Corporations

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Abstract—Concern over the continuing rise in executive compensation and lacklustre company performance has led to an increase in investor and board activity in corporate governance. Institutional investors are leading the new activity and changing the nature of the governance system in the United States. A model of the evolving governance system is presented and relevant characteristics of firm ownership structure and the CEO-board relationship are explored with regard to their impact on the pay-performance link. The results for ownership structure suggest that institutional investors do limit the payment of unearned compensation to the CEO, but that the presence of 5% equity owners has no significant impact. The results concerning the CEO-board relationship suggest that longer tenure as CEO leads to greater compensation, but neither the percentage of outside directors, the director retainer, nor the CEO's years of company service have a significant effect on compensation. Overall, the evidence supports the view that institutional investors are enhancing the accountability of CEOs. The evidence also supports the idea that boards would benefit more from gaining outside directors who are impartial rather than from simply increasing the number of outside directors.

As the rise in executive pay continues to outpace increases in corporate performance and increases in workers' pay (Byrne, 1991), many Americans are questioning the fairness of CEO compensation and the accountability of chief executives. Along with this discontent, and perhaps in response to it, both investors and corporate boards are taking a more active interest in the governance of corporations. The 1992 'board revolt' at General Motors is one sign of increased board activity, and several reports in both the popular and academic literature detail an increase in shareholder activism (e.g., Norton, 1991; Thompson and Davis, 1992; Useem and Gottlieb, 1990).

Institutional investors are leading the new activism, and, in many ways, their growing influence represents a reversal of the decline in ownership power that started at the turn of the century (Useem and Gottlieb, 1990). Since increasing amounts of equity are being held by institutional investors, ownership is essentially becoming less diffuse. For example, the average proportion of a firm's stock controlled by institutions has increased from 15.8% in 1965 to 50.3% in 1992 (Stewart, 1993; Useem, 1992), and the increased activity of these institutional investors can be seen in the 153 'anti-management' proxy proposals they sponsored in 1991, as compared to the fewer than 40 sponsored in 1987 (Thompson and Davis, 1992).

This new-found power and activity of the institutional investor adds a twist to theories of corporate governance. Much of the governance literature has assumed that shareholders are greatly dispersed and inactive, except for the uncommon owner who holds 5% or more of the outstanding equity. Before the 1980s, this assumption was a good approximation of reality. However, given the increasing portion of equity owned by large professional investors, perspectives on governance must now incorporate the role of the large 'owner' who has the means, motivation and organisation to exert pressure on managers, boards and legislators (Thompson and Davis, 1992).

In line with these developments, the purpose of this paper is to explore the structure of the evolving governance system. We give special attention to the increasingly important role of the institutional investor, but our aim is to consider the roles and incentives faced by each of the three major parties involved: the top executives, the shareholders, and the board of directors. The dynamics of governance are modelled and empirically examined with regard to their impact on CEO compensation, since compensation is one area where the board makes significant and frequent decisions (Zajac, 1991), and since executive compensation is both an important instrument of corporate governance and an indicator of its effectiveness.

So far, much of the research on executive compensation has focused on the strength of the link between pay and performance, even though econ-

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omic theory offers little guidance on the appropriate magnitude of the relationship (Baker, Jensen and Murphy, 1988). In reviewing the relevant literature, Finkelstein and Hambrick (1988) conclude that research to date shows executive compensation to be more rational than the harshest critics maintain but less sensible than its architects would like. However, our concern here is not with the strength of the link between pay and performance, but with the impact of the governance structure on the link. We therefore explore characteristics of the CEO-board relationship and the firm ownership structure to see how these different elements of the governance system affect executive compensation, while controlling for firm size and firm performance.

Agency theory and ownership structure

In most large corporations, there is a separation between those who control the firm and those who own the residual claims (Fama, 1980; Demsetz and Lehn, 1985). The agency theory of the firm addresses the problems that arise from this separation, with the two main problems being goal incongruence and information asymmetry between the principals (shareholders) and agents (managers).

When they do not own the residual claims, managers face little direct incentive to maximise the value of the firm. The proper direction must therefore be provided through the structure of the compensation package and through the monitoring of their performance by the owners and the board.[1] Detailed monitoring is costly because of information asymmetry, and thus much of the responsibility for aligning interests depends upon linking the compensation of CEOs to their performance.

The board of directors is responsible for setting executive compensation and assuring that shareholders' interests are protected. However, recent theories and research have cast doubt on the effectiveness of the board as a monitoring body, suggesting that the board may be allowing the CEO to reap undeserved compensation and perquisites (Mizruchi, 1983; O'Reilly, Wade and Chandratat, 1990; Wade, O'Reilly and Chandratat, 1990). In order to protect their investment, concerned investors may need to increase pressure on the board or use other means such as encouraging the payment of board retainers in stock to better align directors' interests with those of the shareholders.

Hence, although agency theory predicts that the separation of ownership from control has efficient properties in terms of risk allocation,[2] some risk borne by executives and directors in the form of equity holdings may be desirable in order to better align interests with shareholder value. Since equity ownership by each party has different implications, it is helpful to consider the different mechanisms by which ownership structure affects the behaviour of executives, directors and external shareholders. The two basic mechanisms are the alignment of interests and the provision of influence. For example, owning a large percentage of a firm's equity may afford a party influence through voting rights and other means. A large percentage may also mean that the holding is a significant portion of the party's wealth, which would provide the party with motivation to protect the investment. Likewise, relatively large holders may face less incentive to shirk their monitoring responsibilities since there are fewer stockholders of comparable size. Each ownership group faces different tradeoffs between maximising firm performance and maximising its own utility through consumption of 'undeserved' pecuniary and non-pecuniary benefits. The different situations facing each party and the empirical evidence are considered below.

External Shareholders

External shareholders have little opportunity for control beyond that which accompanies their stock holdings. Likewise, their motivations are clear in that they desire behaviours that maximise firm performance and generally can gain little benefit from non-value-maximising behaviour. It is therefore in the interest of external owners to pay executives only as much as firm performance warrants and to make sure that there is a strong and explicit pay-performance relationship to align executive motivation with the interests of the 'owners'.

Institutional investors comprise a special class of outside shareholders, one whose role appears to be increasingly important. Useem and Gottlieb (1990) report that the 1980s saw an increase in ownership power as a result of two developments: the increase in concentration of stock owned by institutional investors, representing a reversal of the trend toward ownership dispersion and accompanying shareholder inaction; and the formation of new devices, such as LBOs and proxy contests, allowing owners and would-be owners to assert their influence more effectively. Kosnik (1987) reports evi-

[1]The market for corporate control and the managerial labour market are also mechanisms that provide incentive for managers to act in line with shareholder interests. Moreover, Castanias and Helfat (1991) suggest that managers share the gains of rent producing firms and, therefore, in these firms their interests are generally in line with those of the shareholders. Nevertheless, most theories still hold that monitoring by the board and owners and the explicit linkage of pay to performance are important components of the governance system.

[2]The more dispersed investors are able to diversify risks, and management need not be chosen by its ability and willingness to bear risk (Fama and Jensen, 1983).

dence of the activity of institutional investors in the late 1970s and early 1980s. She found that the proportion of equity controlled by institutional investors was positively related to the board's resistance to greenmail in a study of 110 companies from 1979 to 1983. The proportion of equity held by institutional investors was the third most important determinant of the board's decision to pay greenmail, behind managerial and board equity positions. Measures of board composition figured less prominently and stock concentration among the residual stockholders appeared to have little effect on the greenmail decision.

Likewise, in a study of twelve firms which had experienced intensified shareholder pressures and restructured, Useem and Gottlieb (1990) found several changes in organisational structure and managerial approach that were consistent with the objectives of increasing shareholder value, including a greater use of performance-based compensation schemes. Bilimoria (1992) examined more than 250 of the largest US corporations and found a significantly positive relationship between institutional holdings and the link between pay and performance. We thus predict the following:

> Hypothesis 1: Controlling for size and performance, the proportion of stock held by institutional investors will be negatively related to executive compensation.

Another way to examine the role of shareholders is to consider whether or not a company is 'owner controlled'. In a survey based approach, Tosi and Gomez-Mejia (1989) found that in owner-controlled firms, i.e. firms where a single external stockholder owned more than 5 percent of the stock, major stockholders and boards of directors had more influence over CEO compensation. Gomez-Mejia, Tosi and Hinken (1987) found that executives in firms controlled by external owners received more compensation for performance and less for size than did executives in 'management' controlled firms. Similarly, Tosi and Gomez-Mejia (1992), using results from two surveys, found that compensation 'monitoring', i.e. performance based compensation, was higher in owner controlled firms for both studies. On the other hand, two studies found no significant impact of external ownership on the level of executive compensation (O'Reilly *et al.*, 1988; O'Reilly *et al.*, 1990). The direct empirical evidence is therefore mixed but, given the clear predictions of the theory, we predict the following:

> Hypothesis 2: Controlling for size and performance, firms with at least one external shareholder owning more than 5% equity will provide less CEO compensation.

Board of Directors

Compared to outside shareholders, outside directors have more opportunity for control and face a more complex web of incentives. Their control stems directly from their responsibility as directors and this control can conceivably be augmented by their equity position. Significant equity holdings may increase their influence over management and may also insulate them from the power of external shareholders. The potential increase in power complicates the motivational impact of their equity position. In general, it seems logical that increased equity positions will align the interests of the director with those of the shareholders. However, the increase in power might be used as well to increase their own compensation through pressure on the CEO or other means. Although excess CEO compensation is at odds with shareholder interests, the increase in board retainer would be a more direct and significant increase in wealth than the wealth gained by increasing equity holdings through company performance. Likewise, if there is some sort of *quid pro quo* link between executive and director compensation, then the gains to be had for directors by increasing executive compensation probably outweigh the losses to the directors' stock wealth through decreases in shareholder returns.

Empirical results lend some credence to both of the above arguments, i.e. the incentive alignment and the entrenchment effects of increased board ownership. Kosnik (1990), in a study of resistance to greenmail, found that, in companies whose top management had small equity interests, resistance to greenmail was most likely when the outside directors' equity interests were high relative to their board compensation. Morck, Shliefer and Vishny (1988) found a non-monotonic relationship between Tobin's Q and board ownership. Tobin's Q increases, decreases and increases again as ownership by the board of directors increases. The relationship stands when the holdings of the inside and outside directors are considered separately. The authors suggest that the relationship is the result of two competing forces: increasing interest alignment and increasing managerial entrenchment.

Both forces would tend to increase with increases in equity ownership, but the authors suggest that each force is more potent at different ownership ranges. Increases in equity from 0% to 5% lead to a greater incentive alignment which leads to a higher Tobin's Q. Increases from 5% to 25% lead to a decrease in Tobin's Q because ownership at these levels may be associated with greater managerial entrenchment, e.g. status as founder, increased voting power, increased tenure. Increases in ownership beyond 25% would probably do little to increase entrenchment, so the

increase in Tobin's Q above 25% is likely to be the result of convergence of interest.

Given that our sample is of the 100 largest companies in the US, the proportion of equity owned by directors will probably be relatively small and therefore less likely to afford the type of managerial entrenchment described above. It is, however, still possible for there to be a strong *quid pro quo* relationship between the CEO and the board. With no clear direction for the hypothesis, we will control for board equity in our models.

Top Executives—CEO

As with outside directors, the position of CEO affords a great deal of control over the corporation. Hence, the role of equity holdings is more to align interests and less an issue of providing control. Exceptions include the case where very large holdings may lead to the type of power and entrenchment described above. In general, it would seem that the greater the equity holdings, below the point of entrenchment, the greater the convergence of interest between the CEO and shareholders.

High convergence of interest should generally lead to decisions that maximise shareholder wealth, but the effects on the level of executive compensation are less clear. Although the CEO should officially have little role in setting his or her compensation, some leverage is generally provided through the hiring of compensation consultants, manipulation of performance figures, and influence over the board of directors. In general, efforts to increase compensation that do not greatly hurt the performance of the company will increase the wealth of the CEO more than the relatively small decrease in shareholder wealth will hurt the value of the executive's stock holdings. The loss of a $100,000 of undeserved salary is shared among the other stockholders. Determining the impact of stockholdings on cash compensation is further complicated because stock is generally part of the total compensation package. A CEO who is generally overcompensated will probably receive both more stock and more cash compensation, leading to a positive correlation between the two. Some boards may also tend to substitute stock or options for cash compensation, thereby creating a negative relationship between stock holdings and cash compensation.

Given the many possible causes and directions for the relationship between stock holdings and compensation, it is difficult to make a prediction about the direction of the relationship, but we will control for CEO equity.

Agency theory and the CEO-board relationship

In monitoring and rewarding the CEO, the responsibility for being impartial falls largely on the outside directors. Under the agency perspective, outside directors are assumed to be objective and independent (Fama, 1980; Mizruchi, 1983; Singh and Harianto, 1989). Whereas insiders are understandably under the influence of their superior (the CEO), the outside members are theoretically in a position to resist influence from the CEO and other inside directors. Hence, the compensation committee is composed of outsiders, to help assure that the CEO receives only the appropriate compensation.

Recent empirical findings have, however, cast doubt on the board's ability to govern objectively. This research includes examinations of both the political and group dynamics that affect the board-CEO relationship. For example, Alderfer (1986) explains that size and subgroup diversity of boards can affect their ability to act effectively as a monitoring body.

Political dynamics are explored through the managerialist perspective. Zajac (1991, p. 5) suggests that the compensation setting 'process can be viewed as a negotiation between the board and the CEO, whereby each of the two parties seeks (not surprisingly) to influence the other'. In this survey based study, Zajac found that several individual and socio-political factors predicted whether the compensation setting process was viewed as board or firm controlled. In general, the CEO's ability to influence the board is made easier because outside directors are frequently other CEOs, who may be sympathetic to the desires of their peers (O'Reilly *et al.*, 1990). CEOs may also provide lucrative contracts and consulting assignments to influence outside directors (Singh and Harianto, 1989). In short, the managerialist perspective calls into question the agency assumption of impartial outside directors.

CEO Tenure

There are many perspectives, from both agency and managerialist viewpoints, concerning the impact of CEO tenure on CEO-board relations. Consistent with the agency perspective is the proposition that longer tenure might reflect greater organisation-specific investment by the CEO, and the board should compensate the CEO for his or her risky investment (Singh and Harianto, 1989, p. 21).

From managerial influence perspectives, there are several arguments concerning the effects of tenure on the compensation setting process. Longer tenure may mean greater familiarity with the organisation, which can be a source of power in itself (Singh and Harianto, 1989). Alderfer

(1986) found that board members with a longer tenure shared a common understanding of company operations and of their function as a special group. Pfeffer (1982) explains that longer tenure results in a tendency to show solidarity and to make mutually beneficial choices within a cohort of executives. O'Reilly *et al.* (1990) found that CEOs with greater tenure relative to other board members received greater compensation. The authors explain that longer relative tenure implies that the CEO has appointed more board members and, thus, more board members are likely to be sympathetic to his or her desires.

All these arguments predict a positive relationship between compensation and tenure, resulting in the following hypothesis:

> Hypothesis 3: Controlling for performance and size, CEOs with greater tenure will receive greater compensation.

Board Composition

Evidence on the behaviour of outside directors is found in compensation research and in research that examines other board decisions, such as the decision to adopt golden parachutes or the decision to pay 'greenmail'. Supporting the notion that outsiders are objective, Zajac (1991) found that a higher percentage of non-CEO outsiders on the compensation committee was significantly correlated with a board-controlled compensation process.

On the other hand, O'Reilly *et al.* (1990) predict a positive relationship between the number of outsiders and total cash compensation, citing the social influence perspective. Many outsiders themselves are CEOs and hence are sensitive to CEOs' needs. They may feel a reciprocal obligation and also may have less information with which to evaluate the CEO. Results were in the predicted direction but not nearly significant.

Results from Kosnik's (1987) study on corporate resistance to greenmail support the assumption of objective outsiders. The nature of the impact of greenmail on shareholder wealth has been debated, but the majority of evidence indicates that 'private stock repurchases are in conflict with stockholders' interests if they are used to thwart an imminent threat for the control of a company' (Kosnik, 1987, p. 130). In her study, Kosnik finds that a higher percentage of outsiders increases a board's resistance to greenmail, especially in situations where the executive's incentive for resisting greenmail was small, i.e. the executive has small equity holdings.

Consistent with Singh and Harianto (1989), Wade *et al.* (1990) found a significant positive relationship between golden parachute adoption and the percentage of outsiders appointed after the CEO. The relationship between overall percentage of outsiders and golden parachute adoptions was in the same direction but weaker and not significant. The authors interpreted the results to be consistent with a social influence model: the CEO is likely to have a say in appointing outside directors and thus the chosen directors are likely to be more sympathetic to the CEO's wishes.

However, an alternative interpretation of the results can be made based upon the premise that the adoption of golden parachutes is in line with shareholder interests. The theoretical argument is that golden parachutes make CEOs less resistant to takeover attempts, many of which may benefit the shareholders (Lambert and Larcker, 1985; Singh and Harianto, 1989). In support of this theory, Lambert and Larcker (1985) found positive market reactions to the adoption of golden parachutes. Also, recent work by Cannella and Singh (1991) has shown that CEOs with golden parachutes are more likely to remain with an acquired firm than those CEOs without a golden parachute. Hence, it seems that managers do not necessarily plan on cashing in on the golden parachute, and that golden parachutes may allow CEOs to increase firm-specific investments and undertake risky strategies. Therefore, if golden parachutes are in line with shareholder interests, their adoption is not a sign of an ineffective board. Overall, it seems reasonable to predict that more outsiders would increase the impartiality of the board, at least on the aggregate level:

> Hypothesis 4: Controlling for size and performance, boards with a higher percentage of outside directors will provide less compensation to the CEO.

The Retainer

In recent years more attention is being focused on the compensation paid to the directors themselves. Crystal (1991) has reported a positive relationship between directors' and executives' compensation and suggests that this finding may indicate an inappropriate back-scratching relationship. The relationship is especially suspect given that it is essentially the CEO who sets outside directors' pay. There are, however, other ways to look at this relationship. Rather than an explicit back-scratching scheme, it is conceivable that those directors with higher retainers value their positions more and are thus more inclined to want to please the CEO, which represents a slightly less conscious *quid pro quo* arrangement. Both of these arguments predict the following:

> Hypothesis 5: Controlling for size and performance, the higher the retainer paid to outside directors, the higher the CEO's compensation.

Research design

Method and Sample

A set of simple OLS regression models was run based upon the following structure:

> Compensation = f(Percent institutional ownership, 5% owner dummy, Percent outsider directors, CEO time in position, CEO company service, Director compensation, Board equity, Size, Performance, Error term)

Compensation and board characteristics data for the 100 largest industrial firms in 1988,[3] as determined by the *Fortune 100* list, was obtained from proxy statements. Information on ownership structure and financial performance was obtained from CD Disclosure databases for the fourth quarter in 1988. Although arguments can be made for the relative advantages of other time frames, given possible lag effects of influence, the important point for our cross-sectional methodology is that ownership structures tend to be generally stable over time (Morck *et al.*, 1988). Recent reports also suggest that institutions are holding on to stock longer (Norton, 1991; Thompson and Davis, 1992). Listwise deletion for missing or inappropriate information was used for the models presented in Table 2, with the sample sizes ranging from 79 to 89 as shown.

The sample consists of the 100 largest firms in the US and is therefore not a random sample, so the results may not be generalisable to the total population of companies. They should, however, be somewhat applicable to the *Fortune 500*. And, since companies with assets over $250 million accounted for 60.8% of corporate assets in 1972 (Aldrich, 1979), it is important to study the behaviour of large firms. The sample also relates well to other compensation research, since most of the pay-performance and the golden parachute studies use samples of the largest firms, as collected by *Fortune* or *Business Week*.

Our basic approach was to examine how much variance left unexplained by economic determinants is explained by proxies of the CEO-board relationship. Thus, we needed to include appropriate controls for economic determinants of CEO compensation. The relationship between firm size and executive compensation is probably the best documented relationship in the executive compensation literature (Baker *et al.*, 1988). There also seems to be a link between pay and performance (Murphy, 1985; O'Reilly *et al.*, 1988; O'Reilly *et al.*, 1990), even if it is not as strong as some would like. We therefore included measures of size and performance in each model.

Choice of Measures

(i) Size. Two measures for size were chosen: sales and capitalisation (as measured by outstanding common shares × current price). Sales was chosen because of the previous research documenting its strong correlation with compensation. Correlations using number of employees and assets also show a strong relation to compensation, but sales is stronger. Because of the negative relationship between capitalisation and stock concentration (Demsetz and Lehn, 1985; Morck *et al.*, 1988), we thought it was important to include capitalisation as a size control when exploring the ownership variables.

(ii) Performance. Return on equity (ROE) was the primary measure of company performance. Earnings per share and return on assets were also tested, but ROE showed the strongest correlation.

(iii) Tenure. We chose two measures of tenure, company service and time in position as CEO. CEO time in position refers to the number of years the CEO has spent as the chief executive. Company service is the total number of years the CEO has spent with the company. Using both measures may help to isolate the impact of those factors directly tied to time as CEO from those that are more relevant to general company tenure.

(iv) Board Composition. The measure of board composition (percentage of outsiders) is a straightforward ratio of outsiders to overall board size.

(v) Director Compensation. Finally, the annual retainer for outside board members was chosen as a measure of director compensation. Although not as complex as executive compensation, the structure of outside directors' compensation has its own mix of components that make exact valuation difficult. The retainer should provide an unbiased estimate of the compensation level.

(vi) External Ownership. The measure of external ownership is a dummy variable which indicates whether there are any external shareholders that own 5% or more of the outstanding shares.

(vii) Institutional Equity. The institutional equity measure is a measure of the percentage of outstanding equity held by institutional investors.

(viii) Director Equity. The primary measure of director equity was the total percentage owned by officers and directors. As a secondary measure, the percentage of equity owned by external directors was calculated by subtracting the value of shares owned by the top officers from the total shares owned by officers and directors. The reasoning

[3]Given the nature of our study, the year of the data has particular significance, especially with regard to the role of institutional investors. The activism of institutional investors began to accelerate in the latter half of the 1980s and it appears to be still increasing, so it is likely that our results represent conservative estimates for current shareholder activism. Other studies also found impact of institutional investors for periods in the early 1980s. For example, Kosnik (1987) used data from 1979–1983 to explore corporate resistance to greenmail, and Bilimoria (1992) used data from 1982–1987 to explore the impact on CEO compensation. Both found a significant effect for institutional ownership.

Table 1
Means, Standard Deviations, and Pearson Correlation Coefficients

		Means	SD	1	2	3	4	5	6	7	8	9	10	11
1.	Log Capitalisation	9.8	0.36											
2.	Log Sales	7.0	0.34	0.62										
3.	ROE	0.20	0.11	0.16	−0.12									
4.	% Institutional Ownership	52	12	−0.20	−0.46	0.01								
5.	5% Owner	0.48	0.50	−0.31	−0.17	0.07	0.19							
6.	Log % Equity-CEO	−2.7	0.58	−0.46	−0.36	−0.09	0.01	0.27						
7.	Log % Equity All Officers & Directors	−2.0	0.63	−0.44	−0.45	0.06	−0.08	0.14	0.64					
8.	Log Time as CEO	0.63	0.40	−0.02	−0.06	0.02	0.04	0.01	0.26	−0.01				
9.	Years Service	28	10	0.15	0.20	−0.13	0.02	0.04	0.07	−0.20	0.10			
10.	% Outsiders	0.74	0.13	−0.23	−0.25	0.02	0.12	−0.13	0.07	−0.11	0.14	−0.13		
11.	Log Retainer	4.4	0.11	0.29	0.18	−0.14	−0.20	−0.26	−0.08	−0.06	−0.07	0.01	−0.06	
12.	Log Cash Comp	6.1	0.15	0.47	0.38	0.26	−0.24	−0.07	−0.30	−0.44	0.27	−0.03	−0.03	0.08

$N = 79$
For $r > 0.22$, $p < 0.05$, two-tailed significance.

Table 2
Results of Regression Analysis

	Independent Variables	*Models* *Dependent Variable: Log Cash Compensation* 1	2	3
1.	Log Capitalisation	0.15*** (0.04)	0.12** (0.05)	0.13*** (0.05)
2.	Log Sales	0.09* (0.05)	0.01 (0.06)	
3.	ROE	0.29** (0.12)	0.29** (0.14)	0.28** (0.13)
4.	% Institutional Ownership		−0.0029** (0.0014)	−0.0031*** (0.0011)
5.	5% Owner		0.04 (0.03)	0.04 (0.03)
6.	Log % Equity CEO		−0.0014 (0.04)	
7.	Log & Equity Officers & Directors		−0.09*** (0.03)	−0.10*** (0.02)
8.	Log Time as CEO		0.11*** (0.04)	0.11*** (0.03)
9.	Years Service		−0.0022 (0.0015)	−0.0022 (0.0014)
10.	% Outsiders		0.08 (0.11)	0.08 (0.11)
11.	Log Retainer		−0.0029 (0.14)	0.0006 (0.13)
Constant		3.9***	4.6***	4.7***
Adjusted R^2		0.27	0.41	0.43
N		89	79	79

Standard errors are in parentheses.
$^*p < 0.1$; $^{**}p < 0.05$; $^{***}p < 0.01$.

behind this approach is that junior officers generally own relatively little stock (Morck *et al.*, 1988). Our approach is slightly different from Morck *et al.*'s in that our overall measure includes officers who are not on the board, and we defined the top two officers as those who are paid the most.

(ix) CEO Equity. CEO equity is the percentage of total outstanding shares that the CEO beneficially owns.

(x) Cash Compensation. Cash compensation (salary + bonus) is an appealing dependent variable because it is relatively measurable and unambiguous. Also, unlike stock grants and options, there is no automatic performance indexing of cash compensation. Furthermore, Lewellen & Huntsman (1970) report that cash compensation is a reliable proxy for total compensation.

Finally, several variables were transformed because of their heavily skewed distributions; the logarithm was taken for sales, time in position, board retainer, board and CEO equity, and cash compensation.

Results

Table 1 shows the means, standard deviations and correlations for all variables. Table 2 shows the OLS regression models. Diagnostic tests show no significant violations of the assumptions underlying the OLS model,[4] but collinearity between certain combinations of variables appears high enough to warrant some attention. In general, the collinearity seems to be more of an issue for the control variables (size, inside ownership) than it

[4]In particular, compensation data of this type calls for special attention to the assumption of homoscedasticity; however, diagnostics such as residual plots against the individual variables showed no problems. Furthermore, although DFFITS and DFBETA show a few points to have suspiciously high influence, test runs excluding these points show no significant changes in the results. The data for these points were double checked and included in the presented model. A possible exception is the CEO equity variable, which seems to depend heavily on a few points. However, as discussed below, collinearity seems to obscure the nature of its effects, and its role is that of a control variable.

does for the hypotheses tested.[5] Model three illustrates some of the effects of collinearity by excluding the sales and CEO equity variables.

We found strong support for hypothesis 1. The percentage of institutional ownership showed a significant negative relationship with cash compensation. Hypothesis 2 was not supported. We found that the 5% ownership dummy had no effect. Since most of the 5% owners are likely to be institutions, the results might suggest that 5% ownership is not a meaningful cut-off point for these large institutions.

The control for total board equity shows a strong negative relationship to executive compensation. We thus see no evidence that board or managerial entrenchment leads to higher CEO pay, which is not surprising given the size of the firms in the study. In such large firms it would be surprising to find a significant portion of firm equity controlled by the board. Though not shown here, the measures for equity by external directors show similar effects when used in place of the measure for total board equity. The significant negative impact of both board ownership measures could suggest that directors monitor executive compensation more closely if they bear a greater equity stake. However, the strong correlation between CEO and director equity suggests that the measure of outside director equity might be significantly affected by residual managerial equity holdings. Thus, the negative impact of each of the inside equity measures (total board, outside directors, CEO) could likely be caused at least in part by a substitution relationship between equity and cash compensation: CEOs and other high level executives receive lower cash payments in exchange for options or stock grants.

Hypothesis 3 receives strong support. CEO tenure, as measured by time in the position, is significantly related to cash compensation. Interestingly, total tenure at the company shows no significant relationship and even has a slightly negative coefficient. A strong effect from years as CEO combined with no effect from service suggests that the CEO gains power over the board during his or her tenure through appointing sympathetic outside directors or by other means directly related to the CEO position. Moreover, the source of power does not appear to come from greater equity holdings, since we controlled for CEO equity.

Hypothesis 4 is not supported. The percentage of outside directors shows a slight but not significant positive relationship to cash compensation. Perhaps this finding stems from the preponderance of outside directors on the boards of very large organisations. In our sample the mean board was almost 75% outsiders and there were very few boards that had fewer than 50% outsiders. Our collection of firms might thus already have sufficiently high percentage of outside directors as board members.

Hypothesis 5 receives no support, as the board-member retainer is not significantly related to compensation. From the simple correlations, it does seem that the retainer is positively related to size as measured by sales, suggesting that some similar criteria are used to determine executive and director compensation.

The models on Table 2 indicate that size and performance are both significantly and positively related to cash compensation. Our findings are consistent with previous research that shows size to be strongly related to cash compensation.[6] We also see more evidence of a pay for performance link, however weak or strong. The correlations on Table 1 and the models on Table 2 show that capitalisation is a strong determinant of executive compensation, perhaps stronger than sales. This finding is not surprising given that capitalisation is an indicator of performance as well as size. Companies that are performing well will have relatively high stock prices, and hence ROE probably adds less to the model when capitalisation is included.

Discussion

This study examined the relationships among elements of ownership structure, the CEO-board relationship and executive compensation. By looking at the intersection of these three phenomena, we sought to inform some aspects of each, and it does appear that we can draw some preliminary conclusions. The results supported our hypotheses concerning the important role of institutional investors in monitoring CEO compensation, and we

[5]The two measures for size (sales and capitalisation) are highly correlated, as one would expect. Although the model appears to be underspecified without the sales variable—sales is also highly correlated with institutional ownership—model 3 is presented without the sales measure to illustrate its impact on the other coefficients. Likewise, the different measures of inside ownership are highly correlated, as expected. It appears that the impact of the CEO equity is eclipsed by that of total board equity, although more information would have to be gathered to be certain. Model 3 excludes the measure of total inside ownership to illustrate the effects of collinearity on CEO equity and other variables in the model. Overall, the problems of collinearity do not appear to be too severe regarding the hypotheses tested in model 2. The tolerances are at acceptable levels, and the model passes the rule of thumb test discussed by Kennedy (1992); the t statistics of concern are all above 2. Though sales is not significant in model 2, probably because of collinearity, its importance in executive compensation is well documented and is not of central interest here. Similarly, the sales coefficient is much smaller than usually revealed in the literature, and this may be the result of collinearity with other variables, and, possibly, because we have used cash rather than total compensation as the dependent variable.

[6]Although, as discussed above, the effects from sales appear to be weakened by collinearity in some models.

found that tenure as CEO is a strong determinant of executive compensation. Other hypotheses concerning 5% owners, board composition and directors' retainer were not supported.

The study does have some limitations in that it employs a cross-sectional methodology and the sample is of the largest US organisations. The nature of the sample prevents us from generalising to the total population because of size bias, but the issues explored are particularly germane to large organisations. Also, the cross-sectional nature makes it impossible fully to identify the direction of cause-effect relationships. In the future, it would be useful to examine the dynamic impact of changes in board and ownership structure on executive compensation. For example, longitudinal studies examining the effects of increasing or decreasing institutional ownership would capture lag effects better and could provide a clearer picture of the mechanisms underlying institutional influence. The current results do, however, have interesting implications, which we discuss below.

The finding of a significant negative relationship between institutional ownership and executive compensation is further evidence of the rising importance of the institutional investor (e.g. Kosnik, 1987; Useem and Gottlieb, 1990). It appears that the net result of greater institutional ownership is more effective monitoring. There appears to be a partial closing of the agency gap between principals and agents, as the diffuse body of owners is becoming more concentrated, organised and informed.

Our finding that 5% ownership was not a significant determinant of executive compensation is contrary to other studies (e.g. Tosi and Gomez-Mejia, 1989 and 1992). One reason for the discrepancy might be that our study includes only the largest companies in the US, whereas the other studies examined a greater range of company size. In large companies, such as those in our sample, it is relatively expensive for individual investors to own 5% of the equity. Therefore, many of the 5% owners are likely to be institutions, and the arbitrary 5% cut-off may not be as relevant for institutional owners as it is for individual investors. In line with our finding, Kosnik (1987) found that the percentage of institutional investors is more important than 5% ownership in affecting board resistance to greenmail.

Our findings regarding CEO tenure are in line with other studies that show CEO tenure leading to greater influence over the compensation setting process (Zajac, 1991), and greater relative tenure leading to greater cash compensation (O'Reilly *et al.*, 1990). However, though it is not shown above, we also found the expected positive relationship between tenure as CEO and greater stock wealth. Hence, high tenured CEOs with greater influence over the board may also have their interests more in line with those of the shareholders.

Concerning outside directors, our data shows that the percentage of outsiders has no significant impact on executive compensation. Given that outsiders were in the majority for most of the firms in our sample, the implication may be that improvements in governance will best be achieved by adding outside directors who are more impartial rather than by merely adding a greater number of outside directors. This idea has already taken some hold among shareholders; Norton (1991) reports that nine shareholder resolutions in 1991 requested that companies appoint a majority of independent directors who have a true arm's length relationship with the CEO.

As for executive compensation, our results provide some additional insight into non-economic determinants such as ownership structure and tenure. Also, consistent with other studies, our study shows that economic determinants and performance in particular explain little of the variance. Studies that focus more directly on the strength of the pay-performance relationship may show a stronger link, but the link is still weaker than many would like.

One explanation for the weak link concerns the managerial labour market. Finkelstein and Hambrick (1988, p. 547) argue that inefficiencies within the market distort CEO pay and create the appearance of irrational practices. For example, the authors suggest that because there are no obvious credentials for being a CEO, it is never clear how many 'eligible' candidates exist for a position. Such ambiguities of the CEO talent pool lead to artificial inflations of pay to those who are identified as eligible. Another problem is that compensation consultants focus more on the comparability of CEOs across firms than on their marginal contributions,[7] leading to an artificial homogenisation of pay.

Our results, and other evidence of investor activity, suggest that the institutional investors may be increasing the effectiveness of the managerial labour market. Institutional efforts are compelling directors to look more critically at the performance of CEOs and their value to the firm, which leads to a greater number of CEO ousters and to less pay inflation.

Another difficulty with executive compensation concerns the difficulty in determining the marginal impact of incentive packages. For example, according to agency theory, increases in equity position should better align the interests of the manager with those of the shareholders. Yet we still face the question of how much stock is appropriate. Given that sensitivity to wealth fluctuations may decrease with wealth accumulation, stock or

[7]Although, as Finkelstein and Hambrick (1988) also point out, it is impossible to determine accurately the marginal product of the executives.

option awards beyond a certain point could demotivate managers.

This touches on a problem in restructuring executive compensation through the governance system: it is difficult to control the *level* of executive compensation through board or CEO incentives. Although it is possible to align the interests of management more closely with those of the shareholders through performance based compensation, there will still be a temptation and little penalty for managers and board members to increase each others' compensation. Their immediate gain through an increased level in compensation will outweigh their loss through the reduction in shareholder wealth.

Our results did not show evidence of a *quid pro quo* arrangement between directors and executives, but the theoretical basis of this dynamic is strong. As with the outside directors, it is possible that our sample does not have adequate variance to uncover a relationship. It is also possible that salaries are not actively inflated by this dynamic, but that the structure is still not sufficient to reduce the escalating level of CEO pay.

From an economic efficiency viewpoint, a small amount of overpayment may not be a problem. If both sets of agents are generally acting in a way that is consistent with maximising shareholder value, the additional compensation paid to the executives and directors is probably quite small compared to the overall value of the organisation. However, some of the more recent so-called 'mega' option grants are large enough to have a significant impact on corporate wealth. There is also the potential that sufficiently high overpayment may lead to problems with employees for reasons of perceived (and real) inequity. For example, a recent study by Cowherd and Levine (1992) found that greater pay differentials between top management and lower level employees led to significantly lower product quality.

Since institutional investors do not face the mix of incentives met by executives and directors, they are more likely to address problems such as CEO overpayment. Institutional investors can benefit only by increasing shareholder wealth; thus their increasing power may help to hold down the spiralling level of executive compensation and to generally improve the governance of large corporations.

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Remuneration Committees and Corporate Governance

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Abstract—Using a sample of 220 large publicly held British companies, this study examines the role of the remuneration committee in British boardrooms. Some 30 per cent of the sample reported having such a committee. A reported remuneration committee seemed to be associated with higher levels of pay and made no positive impact on the incentive structure of pay.

Introduction

During the late 1980s the growth in the level of top executive pay in certain UK companies attracted widespread public attention. This led to a closer scrutiny by a wide range of parties, including academics, legislators and the media, of the relationship between the remuneration of the top executive or chief executive officer (CEO) and the performance of the company. In many cases this was found to be wanting or, at best, short-lived. As a consequence, attention turned to the mechanism by which the pay of the CEO was determined. In particular, it was felt that the CEO should not be in the position of deciding his or her own level of remuneration. This sentiment found clear expression in the recent statement of best practice for company directors as issued by the Institutional Shareholders' Committee (1991). Concerning emoluments, the relevant recommendation was:

> A Compensation Committee should be appointed by the Board, consisting solely or mainly of non-executive directors (and in the latter case chaired by a non-executive director).... Executive directors should not play any part in deciding their own compensation packages. The composition of the Compensation Committee should be disclosed in the Annual Report.

More recently, the Cadbury Report (1992) on corporate governance endorsed these recommendations emphasising that the executive directors should play no part in decisions regarding their own remuneration. These statements and reports can be seen as a clear attempt to introduce US best practice into the boardrooms of British companies.

As long ago as 1978 the Securities and Exchange Commission (SEC) introduced the requirement that proxy statements should contain details of the composition, frequency of meeting and purpose of three board subcommittees, namely the Audit Committee, the Compensation Committee and the Nominating Committee. None of these committees was made mandatory, although in 1978 an independent Audit Committee became a requirement for listing on the New York Stock Exchange (NYSE). But there is no doubt that these reporting requirements led the vast majority of companies to set up such committees where they did not already exist. Braiotta and Sommer (1987) report that in 1985 some 86 per cent of the top 1,000 US corporations had compensation committees. Harrison (1987) has drawn out the advantages to directors, in terms of limiting their liability to shareholder suits, that are gained by utilising such sub-committees. By 1990 the existence of compensation committees was virtually universal among large US corporations.

In Britain there is a paucity of information in this area, but it seems that the practice has started to take root. It is now not uncommon to find reference within a company's annual report to the work of the 'Remuneration Committee'. This preferred title may be due to a desire in Britain to avoid any connotation of industrial injuries compensation, etc. But although the title is different, the aim is the same: to oversee the pay determination of the top executives in the company.

This paper attempts to measure the extent to which the open and publicly disclosed existence of such committees has spread to British boardrooms, and to describe the composition and effect of remuneration committees where they can be seen to exist. The second section of the paper describes how our data were collected and the third section discusses some theoretical considerations. The fourth section provides the resulting descriptive statistics and discussion. A summary and policy discussion is given in the last section.

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Data collection

The selection of firms considered in this study is based on two separate but overlapping samples. These two samples are the top 500 companies as ranked by employees from *ELC International, Britain's 10,000 Largest Companies 1991* and the top 500 companies in the *Charterhouse Top Management Remuneration Sample* for 1989/90. Companies were considered for inclusion if they appeared on either list and were also available on Datastream.

Further restrictions were that each company be a UK company with a listing on the London Stock Exchange. Data for each company was taken from the respective Annual Report for 1990. Whilst some of this data was available in machine readable form from Datastream, the detail on board structure and committee membership was only available from scrutinising each company's Annual Report. Stock market performance and share prices are as reported by Risk Measurement Services at each company's financial year end in 1990. After allowing for foreign ownership, incomplete data etc., the sample size was reduced to some 220 companies. A detailed listing of these is given in the appendix. Most large publicly held UK firms are included.

The existence of a remuneration committee was measured by some mention of the existence of such a committee in the 1990 annual report.[1] If a company was operating a remuneration committee but made no mention of the fact in its annual report, it was treated as if it had no effective remuneration committee. This is important as in their confidential dealings with companies ProNed have found that some companies in the UK claim to have a remuneration committee although they do not report the fact in their annual report. It should also be noted that this is an area of rapid change in Britain and many companies may have been in the process of setting up remuneration committees in 1990.

The view taken in this paper is that a properly constituted remuneration committee involves public disclosure of its existence. Such disclosure is recommended not only by the ISC report quoted above but also by ProNed's guidelines on remuneration committees. The effects that are examined in this paper, therefore, refer to a corporate governance innovation that makes the process of determining executive pay more transparent. We ask whether the outcomes in such companies are measurably different from those in companies where the process is less transparent: either in the sense that if there is a remuneration committee its membership and composition are not disclosed to shareholders; or in the sense that there is no remuneration commitee and executive pay is determined by a less structured process, possibly after discussion by the full Board. In terms of experimental design, it would be better to have a clearly designated 'treatment group' (i.e., with a remuneration committee) and another clearly designated 'control group' (i.e., no remuneration committee in existence). As things stand, our control group probably includes some companies who had a remuneration committee but did not disclose the fact. As discussed below, it is felt that, even in this less than perfect design, any differences between the two groups will still be of interest.

The person whose pay is discussed in this study is the director who earned the highest pay (highest paid director, HPD). If this was the Chairman then under the 1967 Companies Act he or she is mentioned explicitly in the annual report along with the relevant emoluments. If it was someone other than the Chairman then we take it to be the person identified as the chief executive officer or managing director in the company's report. This procedure will lead to an unavoidable error where an executive who is neither the Chairman nor the chief executive officer is the highest paid director. It is thought that among these large companies such eventualities are extremely rare for the UK based employees to whom the data relate.

Top executive pay and corporate governance

On theoretical grounds there is much to commend the governance innovation of setting up remuneration committees. The complexities of present day remuneration packages demand a degree of expert knowledge and specialised information. If pay is to be linked to performance then it seems wise to give some attention to this detail, and it also seems wise that the dominant perspective on such matters comes from those who most obviously represent the shareholders, i.e., the Board and the non-executives in particular.

The pivotal role of the Board emerges clearly from principal-agent considerations as presented in Fama (1980), and Fama and Jensen (1983) where the 'expert board' is seen to enforce its 'ratification and monitoring' of top management through its 'power to hire, fire, and compensate the top level decision managers' (Fama and Jensen 1983, pp. 302 and 311). The transaction cost analysis of Williamson (1985) leads to a similar emphasis on the role of the Board in the sense that 'the board of directors should be regarded principally as a governance instrument of shareholders' (Williamson 1985, p. 324). From Williamson's perspective (1985, p. 313), in the absence of an

[1] In the few cases where the 1990 annual report was not available, the nearest available year (usually 1989) was used.

independent remuneration committee managers would:

> appear to write their own contracts with one hand and sign them with the other.

An arrangement such as the remuneration committee places great influence in the hands of the non-executive directors. Authors such as Lorsch (1989) and Mace (1971) have looked sceptically at the ability of outside directors to exert influence over a company. And recently Jensen (1989, p. 64), in a marked departure from some of his earlier writings, has stated the case forcefully:

> the idea that outside directors with little or no equity stake in the company could effectively monitor and discipline the managers who selected them has proven hollow at best.

Hermalin and Weisbach (1988) present evidence to suggest that the composition of the Board is, to some extent, determined at the discretion of the CEO. In Canada, Earle (1989) found in three case studies that compensation committee members were much influenced by external evidence provided by compensation surveys and were in some cases beholden to the CEO. This is a view long promoted in the USA by Crystal (1988, 1989, 1991).

Evidence from the USA (Main, O'Reilly and Crystal, 1992 and O'Reilly, Main and Crystal 1988) suggests that there are strong social influence considerations that affect the pay awards granted by remuneration committees. These authors also invoke consideration of what Tversky and Kahneman (1974) term 'anchoring', whereby the pay received by a non-executive director in his or her own company will influence what he or she deems to be a reasonable level of pay to award another executive in a similar position. And this perspective conditions their decisions while serving as outside directors on the remuneration committee of another company. This will then link the pay they themselves receive and the pay they help award through any remuneration committee on which they sit.

The general area of pay and performance has recently been surveyed by Rosen (1990) who highlights the limits of monitoring by the Board of Directors of the CEO's performance and argues in favour of a contractual approach. But who is to design and police the contract? This seems merely to hand the problem back to the remuneration committee.

It seems, therefore, that although there are some questions raised about the effectiveness of the arrangement, there are strong theoretical reasons for expecting a Board sub-committee such as the remuneration committee to exert an influence on top executive pay. And that influence should be in the interests of the owners, i.e., the shareholders. We now turn to an examination of the evidence concerning remuneration committees (as publicly disclosed) and their influence in the UK.

Evidence on remuneration committees

The previous section emphasised the role that the Board of Directors plays in the governance of widely held public companies. This section starts by asking what factors are associated with the public disclosure of a particular Board sub-committee, the remuneration committee. Clearly the size of the company and the size and composition of the Board will be influential. Larger firms are known to pay their top executives more (see Rosen 1990), and that high level of pay brings with it a need for greater transparency and formal control mechanisms. Similarly the size and composition of the Board determines the scope for a sub-committee structure. And, finally, as the erection of this new governance device is to some extent a leadership issue, the personal characteristics of the highest paid director, length of time in the job, time on the Board, time with the firm etc., may well be influential.

As Jensen, Baker and Murphy (1988) and Rosen (1990) make clear, there is a strong, almost universal, relationship between sales and top executive pay. And where executive pay reaches high levels and, possibly, becomes more sensitive in a public relations sense, its determination is more likely to be subject to special procedures. It is, therefore, not surprising to find that remuneration committees are far more common among higher turnover firms. This is clearly demonstrated in Table 1. But personal characteristics such as the length of time the highest paid director (HPD) has been either in office, on the Board, or with the firm seems to be unimportant. So too is the executive's age. Part of the association revealed in Table 1 between the presence of a remuneration committee and the number of directors on the Board (NDIR) and, more importantly, the number of non-executive directors (NEDS) is clearly definitional. It is necessary to have some non-executive directors to constitute a remuneration committee!

Within the 30 per cent of the companies that reported having a remuneration committee, some 83 per cent reported also having an audit committee, and 85 per cent of those with an audit committee also had a remuneration committee. If the highest paid director was also the company chairman then there was a slightly greater probability of there being a remuneration committee (0.33 versus 0.29 where the offices were separate).

The level and composition of the highest paid director's pay is examined in Table 2. Three components of pay are given: total emoluments (current pay of the highest paid director, HPD) as reported under requirements introduced in the

1967 Companies Act; the value of shareholdings; and the value of option holdings. The last two are added together to produce a measure of long term compensation or long term incentive. These measures are imperfect and not strictly comparable. The first is a 'flow' or income measure and, pension contributions apart, is comprehensive. The second two are 'stocks' or wealth measures valued at the share price at the year end. A more comparable measure would have been the value of the options actually issued to the highest paid director in a given period as predicted by the Black-Scholes option pricing formula. But this requires detail on strike prices, exercise restrictions and timing of issue that are not generally available. The long term compensation components in Table 2 are therefore only a proxy of this aspect of remuneration.

The average level of current compensation is £266,309, the average market value of option holdings £731,905 and of shareholdings £5,487,997. As expected, both current emoluments and option value rise strongly with sales. Table 2 shows the value of shareholdings to peak for medium size firms, a finding which seems to be associated with entrepreneurial highest paid directors. This is a point to which we return below. The disclosed presence of a remuneration committee seems from this simple analysis to be associated with higher current emoluments (HPD) at an average of £313,478 with a declared remuneration committee and an average of £245,654 for the rest. Similarly, publicly declared remuneration committees are associated with higher values of option holdings, but with lower values of shareholdings. The fact that the highest paid director sits on the remuneration committee does not appear to increase his current emoluments, but it is associated with a reduction in the level of options that he holds. Being Chairman brings higher levels of compensation. And there is little evidence here that larger representations of non-executive directors hold pay in check.

Table 3 demonstrates that British Boards are of modest size with almost two thirds of this sample comprising ten or fewer directors. The representation of non-executive directors shows little change since the analysis for 1981 by Cosh and Hughes (1987) who found an average proportion of non-executives of 37 per cent in their sample of Boards. Here the average is also 37 per cent. These findings are broadly in line with those of the Bank of England (1985). Possibly due to pressure from the city for split roles of CEO and Chairman, there are now only around one quarter of CEOs who are also Chairmen. And although a non-executive

Table 1
The Proportion of Companies with a Remuneration Committee

Characteristic	*Sales*[1]	*NDIR*[2]	*NEDS*[3]	*HPD Tenure*[4]	*Board Tenure*[5]	*Firm Tenure*[6]	*HPD*[7] *Age*
High	0.40	0.37	0.43	0.35	0.40	0.39	0.31
Medium	0.35	0.38	0.47	0.41	0.35	0.37	0.39
Low	0.17	0.09	0.06	0.35	0.43	0.37	0.31
N	220	220	220	171	150	136	193

Notes

[1]Based on total Sales in 1990 where High > £1,500m; Medium is between £500m and £1,500m; and Low < £500m (per annum).

[2]The total number of Directors for the financial year ending in 1990 where High is NDIR > 10; Medium is 8 ≤ NDIR ≤ 10; Low is NDIR < 8.

[3]Total number of Non-Executive Directors for financial year ending in 1990 where High is NEDS > 4; Medium is 3 ≤ NEDS ≤ 4; Low is < 3.

[4]HPD tenure is length of time that the HPD, as of 1990, had been the HPD (Highest Paid Director), where High is HPD Tenure > 5; Medium is 3 ≤ HPD Tenure ≤ 5; Low is HPD Tenure < 3 years. Information only available in 171 cases.

[5]Board Tenure is the tenure of the current HPD on the Board of Directors where High is Board Tenure > 15 yrs; Medium is 6 yrs ≤ Board Tenure ≤ 15 yrs; and Low is Board Tenure < 6 yrs. Information only available in 150 cases.

[6]Firm Tenure is duration of the current HPD's Tenure with the firm where High is Firm Tenure > 25 yrs; Medium is 10 yrs ≤ Firm Tenure ≤ 25 yrs; and Low is Firm tenure < 10 yrs. Information available in only 136 cases.

[7]HPDAGE is the age of the HPD as of 1991 where High is HPDAGE > 57; Medium is 50 ≤ HPDAGE ≤ 57; Low is HPDAGE < 49. Information available in only 193 cases.

Table 2
Pay (£) Composition by Company Characteristics

		HPD[1]	Option Value[2]	Value of Share Holding[3]	Long Term Investments[4]
Sales[5]	High	387,904	1,251,845	5,851,972	7,103,817
	Med	260,732	647,726	8,875,729	9,523,455
	Low	154,723	311,130	1,973,532	2,284,662
	(N)	(220)	(220)	(220)	(220)
Does the Company have a Remuneration Committee?					
	Yes	313,478	839,349	795,502	1,634,851
	No	245,654	684,854	7,542,879	8,227,733
	(N)	(220)	(220)	(220)	(220)
Is the HPD on the Remuneration Committee?[6]					
	Yes	294,000	603,937	668,824	1,272,761
	No	327,462	1,008,363	886,451	1,894,814
	(N)	(67)	(67)	(67)	(67)
Is the HPD also the Chairman?					
	Yes	304,120	868,410	7,418,800	8,287,210
	No	218,360	558,810	3,039,600	3,598,410
	(N)	(220)	(220)	(220)	(220)
Were one third or more of the Board NEDs?					
	Yes	275,818	763,128	1,850,831	2,613,959
	No	248,649	673,918	12,242,731	12,916,949
	(N)	(220)	(220)	(220)	(220)
All		266,309	731,905	5,487,997	6,219,902
		(220)	(220)	(220)	(220)

Notes

[1]HPD is the level of the highest paid director's (HPD) remuneration for 1990.

[2]Option Value is the number of share options held at the financial year end in 1990 multiplied by the quoted share price at that time.

[3]This is the HPD's personal holding of company ordinary shares prevailing at the financial year end in 1990 multiplied by the company's quoted share price at the year end.

[4]Long Term Investments is the sum of the values of personal shareholding and options (i.e. columns 2 + 3).

[5]Sales as defined in Table 1.

[6]Only available for those companies with a remuneration committee.

director as Chairman of the Board would seem to be one obvious remedy for the principal-agent problem of separation of ownership and control, there are remarkably few such situations. Some 17 per cent of the sample fall in this category.

In general there seem to be a sufficiency of non-executives on most Boards to comprise a remuneration committee. But, where a remuneration committee does exist, it is not, in fact, the sole province of non-executives. Table 4 illustrates that 42 per cent of the highest paid directors whose companies have remuneration committees serve on that committee themselves. They may, of course, absent themselves while their own pay is discussed. There may also be a sequenced structure of remuneration committees with only non-executives determining the pay of the very highest executives but with those executives participating in committee consideration of more junior executives. The subsequent columns of Table 4 demonstrate that in larger remuneration committees it is not uncommon to have two executives sitting on the committee. The detailed composition of remuneration committees is examined in greater detail in Main and Johnston (1992).

In an attempt to determine whether the publicly declared existence of a remuneration committee influences the level of CEO pay, other things equal, a regression analysis is reported in Table 5. The dependent variable is the logarithm of current

Table 3
Board Size and Characteristics

Total Number of Directors on the Board	*The Proportion of the Board who are Non-Executive Directors*	*The Proportion with Chairman and CEO Combined*	*The Proportion of Chairmen who are Non-Executive Directors*	*N*
	%	%	%	
1–6	29	23	23	31
7–8	34	23	23	53
9–10	40	26	21	61
11–12	36	20	10	30
13–14	44	28	6	32
15–16	35	40	0	5
17–24	35	25	0	8
All	37	25	17	220

compensation of the highest paid director (HPD). An attempt is made to control for the size of the company, its performance and its ownership structure. A descriptor of whether or not the company declares having a remuneration committee is included to see if this makes any difference to pay, given the descriptors of size and performance. Ownership structure is described by whether the highest paid director can be regarded as 'entrepreneurial', i.e., having a large ownership stake and therefore in less need of any incentive alignment—and also less likely to look to large pay awards as an important means of personal wealth enhancement. To this end, the control variables used in Table 5 are the logarithm of company turnover (sales), stock market return (risk adjusted), a dummy variable indicating the presence (= 1) or absence (= 0) of a reported remuneration committee, and a dummy variable describing whether the highest paid director can be described as an entrepreneur or owner-manager (defined by the value of share-holdings exceeding ten times current emoluments).

In this specification (column 1 of Table 5) the remuneration committee variable seems to be associated with a level of pay that is higher by a statistically significant 21 per cent.[2] Given that the average level of pay in this sample is £266,309, this implies that a reported remuneration committee is associated with a pay increase of some £56,000. The statistical significance and size of this effect declines somewhat (to 17 per cent) as the ratio of non-executive to total directors is introduced (column 2, Table 5). This too increases the pay of executives rather than holding it in check. Personal variables such as the length of time the executive has been in his position, or has served with the company, play no significant role and are not included here, owing to the restricted availability of these descriptors. Whether or not the highest paid director is the chairman or is both chairman and CEO (as opposed to simply being the CEO) has no significant impact on his pay (Table 5, column 3). Looking only at those companies that declare having a remuneration committee, the fact that the CEO himself serves on that committee makes no difference to his pay award (Table 5, column 4). However, in such cases if the HPD is both the chairman and the CEO then this is associated with a 40 per cent increase in his current emoluments.

As the remuneration committee may be thought of as a mechanism for effecting an alignment of management's (agents') incentives and principals' (owners') interests, it may be more enlightening to examine pay structure rather than pay level. In terms of incentive alignment, the question then becomes whether the existence of a reported remuneration committee influences the structure of this package in favour of the long term component, i.e. option value. This would be consistent with the remuneration committee acting to strengthen the alignment of incentives with respect to company performance through the structure of executive pay, an action that might be thought to be high on the agenda of any remuneration committee.

The dependent variable in Table 6 is the fraction of total compensation (defined here as current pay plus the market value of options held) which is in the form of options. As before, the descriptive variables condition on the size of the company, performance and the structure of governance. A measure of the level of total compensation (the logarithm of current pay plus option value) is also included as a control variable as we wish to

[2]Given the logarithmic specification of the dependent variable, the marginal impact on HPD of the remuneration committee can be obtained by taking the exponential of the coefficient 0.193. Hence the 21 per cent figure.

Table 4
Size of the Remuneration Committee and Membership

Size of Remuneration Committee	Is the HPD a Member of Committee?	Number of Committees	Number with			
			0 execs	1 execs	2 execs	3+ execs
	%					
1–2	0	4	3	1	0	0
3	28	18	10	6	1	1
4	23	13	9	2	2	0
5	60	20	6	8	6	0
6–9	67	12	4	5	1	2
All	42	67	32	22	10	3

concentrate on the structure of pay rather than its level. The question is, therefore: for a given level of executive compensation does the presence of a reported remuneration committee make any difference to the way that the pay package is structured in terms of long term incentives versus current pay? We ignore shareholdings in this analysis as, while the remuneration committee can be expected to influence the executives' current pay and stock option holdings, it is far more difficult to prescribe the level of the executives' holding of shares.[3]

It can be seen from the results[4] in column (1) of Table 6 that while size plays a significant role, performance does not. In terms of governance structure, the entrepreneur indicator is clearly significant. Such individuals tend to have high values of shareholdings but few options. Unsurprisingly, high levels of total remuneration packages tend to be more oriented towards options. Once a given level of 'cash' wage payment is secured it becomes easier (from a risk viewpoint) to accept increasing proportions of additional pay in the more risky form of options. The executive/non-executive composition of the board and whether the HPD is chairman and/or CEO seems to make little difference to the incentive structure of the remuneration package. The declared existence of the remuneration committee itself plays no significant role. The expected coefficient on this variable would be positive if the declared existence of the remuneration committee were to increase the proportion of pay taken in the performance contingent form of stock options. But the estimated coefficient on this variable (−0.045) is empirically small and in a statistical sense seems, if anything, to be non-positive.

For those companies that report the existence of a remuneration committee, column (2) of Table 6 indicates that the higher the level of sales the lower the level of options held by the CEO. Also, in those companies where the highest paid director is both the chairman and CEO, there is a tendency for the highest paid director to hold relatively few options and, therefore, have less long term incentive. On the other hand there is no indication that the HPD's membership of the remuneration committee has any statistically significant effect on the composition of his pay.

Summary and policy discussion

From the analysis above it appears that remuneration committees have established a place in British company boardrooms. Some 30 per cent of our 1990 sample of 220 large companies reported operating such a sub-committee of the board. Very large companies (sales over £1.5b) were somewhat more likely to have adopted this administrative innovation (at 40 per cent) than the smaller companies (sales below £500m) in our sample (at 17 per cent). Apart from the obvious fact that one requires a number of non-executive directors to create a meaningful remuneration committee, there were no other visible institutional precursors to such an arrangement.

Typically around one third of the Board members of these sample companies were non-executive, and in around one quarter of the companies the CEO was also the chairman. The composition of the remuneration committee, where one existed, did not always consist entirely of non-executives. It was not uncommon (in around two fifths of the cases) to find the highest paid director serving on his own remuneration committee. In one case in five there were two or more executives on the committee. In less than half of the cases was the remuneration committee made up entirely of non-executives.

[3]One way to achieve this is to issue the executive with 'restricted stock'. But as Main *et al.* (1992) make clear, this is equivalent to a stock option with diminished downside risk.
[4]As in Table 5, White standard errors are used in computing the *t*-statistics. This provides some safeguard against any heteroscedasticity present.

In a regression analysis that attempts to control for size and performance of each company, the level of pay awarded to the top executive was found to be, if anything, higher in the presence of a reported remuneration committee. In terms of the average highest paid director's pay (£266,309) this effect was worth some £45,000 to £56,000.

However, the purpose of a remuneration committee is not specifically that of holding down the level of pay. Neither is it, of course, to boost pay levels. As discussed above, if the remuneration committee can be looked upon as a governance mechanism of control by the owners (principals) over top management (the agents) then the general expectation from a remuneration committee is that pay will, in the interest of the shareholders, be tied more closely to performance. Alternative views of the remuneration committee as a high level pay tribunal or, as ProNed (1992) suggest, a legitimating device, do not lead to this conclusion. Empirically, when the structure of pay is examined, i.e. the breakdown between pay in cash and pay in the form of stock options, there is no significant positive effect that can be attributed to the declared existence of a remuneration committee. On the other hand, in terms of both the level of pay and the structure of pay, the presence of the highest paid director as a member of the remuneration committee made no difference. From this evidence, at least, the natural alarm at seeing executives sit on the committee that determines their own pay seems to be unfounded.

There are, of course, weaknesses in the empirical work presented here. Our requirement that a remuneration committee be measured by the public disclosure of its existence in the company's annual report may be unnecessarily strict. Included in the 'no remuneration committee declared' group (some 153 out of our 220 sampled companies) will be companies which do in fact operate a remuneration committee but do not choose to declare the fact in their annual report. This oversight would lead to a reduction in the measured effect of the remuneration committee, as the comparison would be between a group of companies with remuneration committees and a group some of whom did and some of whom did not have remuneration committees. Any bias would, therefore, tend to favour a 'no difference' result. In addition, the measure of long term compensation employed is far from perfect. It measures the current market value of the highest paid director's option holdings at one point in time. With fuller information on the dates and quantity of issue of stock options to the HPD, the exercise or strike price and any restrictions on date of exercise, a more precise figure could be deduced. But British company accounts

Table 5
Top Executive Pay as a Function of Company Characteristics (log of total current compensation in £000s) (*t-statistics in parentheses**)

Independent Variable	(1)	(2)	(3)	(4)
Constant	1.875	1.676	1.754	2.385
	(4.56)	(4.20)	(4.18)	(2.79)
Log of sales	0.254	0.255	0.245	0.225
	(8.42)	(8.50)	(7.42)	(4.05)
Market return	0.100	0.067	0.044	0.512
	(0.74)	(0.52)	(0.33)	(1.31)
Remuneration committee	0.193	0.156	0.154	—
	(2.55)	(2.03)	(2.04)	
Entrepreneur	0.191	0.236	0.211	0.004
	(1.87)	(2.39)	(2.00)	(0.03)
Ratio of non-executives to executives	—	0.515	0.521	−0.007
		(2.34)	(2.20)	(0.01)
HPD chairman and CEO	—	—	0.127	0.339
			(1.39)	(2.28)
HPD chairman only	—	—	0.065	0.190
			(0.75)	(1.14)
HPD on the remuneration committee	—	—	—	−0.030
				(0.21)
Adjusted R-squared	0.34	0.36	0.36	0.24
F Statistic	29.58	25.16	18.30	43.95
N	220	220	220	67

*Based on White corrected standard errors.

Table 6
Highest Paid Director's Remuneration Structure as a Function of Company Characteristics (options/(options + pay)) (*t-statistics in parentheses**)

Independent Variable	(1)	(2)
Constant	−2.624	−2.451
	(14.40)	(6.01)
Log of sales	−0.064	−0.095
	(5.47)	(4.31)
Market return	−0.060	−0.036
	(1.29)	(0.23)
Remuneration committee	−0.045	—
	(1.69)	
Entrepreneur	−0.077	−0.165
	(2.05)	(1.37)
Ratio of non-executives to executives	0.070	−0.200
	(0.77)	(1.23)
HPD chairman and CEO	−0.046	−0.114
	(1.58)	(2.45)
HPD chairman only	−0.035	−0.088
	(1.15)	(1.64)
Level of remuneration	0.304	0.334
	(17.89)	(9.83)
HPD on the remuneration committee	—	−0.022
		(0.44)
Adjusted R-squared	0.68	0.66
F statistic	58.88	16.94
N	220	67

*Based on White corrected standard errors.

are, by and large, less than transparent with regard to such matters.

It remains, however, that there is little empirical support for the arguments whereby the remuneration committee can be viewed as an extension of corporate governance that tailors executive pay to produce incentive effects that are to the benefit of shareholders. There are, of course, alternative predictions of how the committee can effectively work in the interests of management by enhancing or at least legitimating their levels of pay. In this sense the results are consistent with the analysis of the US counterpart to the remuneration committee, the compensation committee. According to Crystal (1991), Main *et al.* (1992), and O'Reilly *et al.* (1988), the compensation committee has been to some extent captured by the incumbent management.

If remuneration committees are to assume a major role in crafting executive pay, then the selection and composition of those committees becomes of major importance. This leads to the question of who serves as non-executive directors. Rather than seeing the evidence presented above as undermining the movement towards establishing remuneration committees as an important facet of corporate governance, it might be taken as an incentive to reform the nomination process by which non-executive directors are appointed. And here there is clearly scope for greater stockholder activism—a point clearly made in Charkham (1989) and investigated further in Main and Johnston (1992).

Jensen and Murphy (1990) have argued that political forces rule out the very high pay awards that would be necessary to provide a desirable amount of pay-performance sensitivity at the top of large corporations. But the evidence presented here raises some doubts as to whether, even if such headroom were available, the institutional forces within the large business organisation would permit a sufficiently incentive aligned pay package to emerge. In the present environment, setting up a remuneration committee certainly seems to be no quick solution.

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APPENDIX

Firms and HPD's Included in the Study (in order of size) (N = 220)

British Petroleum	R. Horton
Shell Transport	Sir P. Holmes
BAT Inds	Sir P. Sheehy
Imperial Chemical Inds	Sir D. Henderson
British Telecom	I. Vallance
Grand Metropolitan	Sir A. Shepherd
British Gas	R. Evans
Hanson	Lord Hanson
Sainsbury, J.	Lord Sainsbury
BTR	Sir O. Green
Marks & Spencer	Lord Rayner
Tesco	Sir I. MacLaurin
General Electric Company	Lord Weinstock
British Airways	Lord King
Allied Lyons	R. Martin
Dalgety	M. Warren
Bass	I. Prosser
Saatchi & Saatchi	M. Saatchi
Hillsdown Holdings	H. Solomon
Thorn EMI	C. Southgate
Rolls Royce	Sir R. Robbins
Tarmac	Sir E. Pountain
Ladbroke Group	C. Stein
BICC	R. Biggam
ASDA	Sir G. Messervy
Guinness	A. Tennant
Boots	Sir J. Blyth
Tate & Lyle	N. Shaw
Inchcape	Sir G. Turnbull
Cadbury Schweppes	N. Cadbury
Lonrho	R. Rowland
Trafalgar House	E. Parker
Booker	J. Taylor
Pilkington	Sir A. Pilkington
Glaxo Holdings	Sir P. Girolami
Assd. British Foods	G. Weston
BOC Group	R. Giordano
Courtalds	Sir C. Hogg
GUS	R. Pugh
STC	A. Walsh
RMC Group	J. Camden
BET	N. Wills
Unigate	J. Clement
United Biscuits	R. Clarke
Cable & Wireless	Lord Sharp
Beazer	B. Beazer
Burmah Castrol	L. Urquhart
Lucas	T. Gill
Hawker Siddeley	A. Watkins
W. H. Smith Group	Sir M. Field
Sears	G. Maitland Smith
Whitbread	P. Jarvis
GKN	D. Lees
AMEC	A. Cockshaw

Racal Electronic	Sir E. Harrisson
Berisford	J. Slater
Geo Wimpey	Sir C. Chetwood
Alfred MacAlpine	R. MacAlpine
Smiths Inds	F. Hurn
B A A	Sir N. Payne
Steetley	R. Miles
Fitch Lovell	F. Hawkins
Daily Mail & General Trust	C. Sinclair
Marley	G. Russell
B.S.G. International	T. Cannon
Powell Duffryn	B. Andrews
Wickes Group	H. Sweetbaum
Mecca Leisure Group	G. Guthrie
Morgan Crucible	E. Falmer
Transport Devlpt Group	Sir J. Duncan
Barratt Developments	J. Swanson
Rugby Group	P. Carr
Amstrad	A. Sugar
Hazelwood Foods	P. Barr
Foseco	R. Jordan
Bibby, J.	R. Mansell-Jones
Simon Engineering	B. Kemp
T. Cowie	T. Cowie
Securicor Group	R. Wiggs
Tootal	G. Maddrell
Geest	D. Sugden
Owners Abroad	H. Klein
Greenall Whitley	A. Thomas
Blackwood Hodge	K. Scobie
Laird Group	J. Gardiner
Queens Moat Houses	J. Bairstow
Appleyard	M. Williamson
Security Services	R. Wiggs
Laporte	K. Minton
Charter Consolidated	J. Herbert
Dawson International	P. Dawson
Norcross	M. Doherty
Yale & Valor	M. Montague
Westland Group	A. Jones
Hickson International	T. Robson
Hunting Assd Inds	K. Miller
Y J Lovell	R. Groves
Electrocomponents	Sir K. Bright
Plaxon	D. Matthews
Evans Halshaw	A. Dale
Davies & Newman	N. James
Lookers	W. Martindale
Croda International	K. Hopkins
David S. Smith (Hldgs)	P. Williams
McKechnie	M. Ost
Haden MacLellan	A. Geiger
Low, Wm.	J. Millar
London International	A. Woltz
De La Rue	J. Marshall
Perry Group	R. Allan
Ibstock Johnsen	L. MacLellan
Heywood Williams	R. Hinchcliffe
McCarthy	I. Parsons
Batleys of York	L. Bateley
Lilley	R. Rankin
Senior Engineering	D. MacFarlane
Bullough	D. Battle
Howden Group	K. Johnsen

Hestair	D. Hargreaves
Central Ind. TV.	B. Ripley
Low & Bonar	P. Jarvis
Rentokil	C. Thomson
Chloride Group	R. Horrocks
Laura Ashley Holdings	Sir B. Ashley
Unitech	P. Curry
Bryant Group	A. MacKenzie
Scapa Group	R. Goodall
EMAP	R. Miller
Stavely Industries	B. Kent
A B Electronics	E. Merrette
Thames TV	R. Dunn
Dobson Park Industries	A. Kaye
Acatos & Hutcheson	I. Hutcheson
SD-Scicon	P. Swinstead
Avon Rubber	A. Mitchard
Calor Group	D. Mitchell
Evered	P. Tom
Sketchley	M. Glenn
Portals Group	M. Morley
James Finlay	R. Muir
Alexon Group	D. Cohen
Mount Charlotte	B. Peel
Securiguard	A. Baldwin
Stakis	A. Stakis
Johnston Group Cleaners	T. Greer
Boddingtons	H. Reid
S R Gent	P. Wetzel
Greggs	M. Darrington
VSEL Consortium	C. Davies
Wood, S W	B. Giddings
African Lakes	P. MacKenzie
RCO Holdings	A. Raven
Leeds Group	R. Wade
Daniels, S	P. Daniels
Wiggins Group	G. Lansbury
Dewhurst	T. Dewhurst
Wolseley	H. Lancaster
Coats Viyella	N. Bain
Burtons	Sir J. Hoskyns
LEX Service Group	Sir T. Chinn
Harrisons & Crossfield	G. William Paul
Rank Hovis MacDougall	S. Metcalfe
Dixons	S. Kalms
Reckitt & Coleman	J. St. Lawrence
Ultramar	J. Darby
Plessey	Sir J. Clark
Reed International	P. Davis
Rothmans International	Lord Swaythling
Pearson	Viscount Blakenham
John Mowlem & Coy.	Sir P. Black
John Lang	M. Laing
Johnson Matthey	R. Wakeling
Costain	P. Costain
Wellcome	Sir A. Frame
Cookson Group	R. Oster
Bunzl	D. Kendall
Kwik Save Group	J. White
Granada	A. Bernstein
The LEP Group	J. Read
Siebe	E. Stephens
Rank Organisation	M. Gifford
Storehouse Group	M. Julien

Redland	Sir C. Cornes
Taylor Woodrow	P. Drew
Bowater	J. Lyon
T & N	C. Hope
ECC Group	A. Teare
Maxwell Communications	R. Maxwell
Scottish & Newcastle	A. Rankin
BBA Group	J. White
Blue Circle Industries	J. McColgan
Fisons	J. Kerridge
Polly Peck International	A. Nadir
Nurdin & Peacock	D. Rowley
Glynwed International	G. Davies
Northern Foods	C. Haskins
Jaguar	Sir J. Egan
Tozer, Kemsley & Mill	R. Heath
BPB Industries	A. Turner
FKI	N. Scoular
IMI	C. Allen

AAH Holdings	B. Pybus
WPP Group	M. Sorrell
APV	F. Smith
Next	D. Jones
Ratners	G. Ratner
TI Group	C. Lewinton
Gestetner	B. Sellars
Williams Holdings	A. Rudd
United Newspapers	Lord Stevens
Hunting	K. Miller
News International	A. Knight
Delta	R. Easton
Vickers	Sir D. Plastow
Morrison, Wm.	K. Morrison
DRG	J. Moger Wooley
Dowty	A. Thatcher
Smith & Nephew	J. Robinson
Iceland Frozen Foods	P. Hinchcliffe
Tomkins	G. Hutchings

Executive and Employee Share Options: Taxation, Dilution and Disclosure

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Abstract—Share option schemes have grown substantially in the UK in recent years. Disclosure requirements have not kept pace with innovation, and fuller disclosure of directors' option rewards has been among the recommendations of institutional shareholders on corporate governance. The current requirements are the result of unhappy historical accident; they are simultaneously complex and incomplete, achieving patchy compliance. When servicing option schemes, companies are able to choose between issuing new shares and purchasing existing shares. The choice has implications for dilution of equity, disclosure in financial statements and liability for corporation tax. This paper develops a comparative analysis of the post-tax cost of options which indicates that purchase is likely to be the cheaper method, and goes on to show that statutory disclosure requirements are less demanding when options are satisfied by the purchase of existing shares. Many companies nevertheless continue to use schemes involving subscription to new shares. The implications of that paradox are examined, and effective ways of meeting the demands of institutional investors for improved governance and disclosure are considered.

Introduction

Share option schemes have become a familiar feature of the UK corporate scene in recent years. Companies normally have at least two schemes, an executive share option scheme confined to certain sections of management, including executive directors, and an employee scheme open to all employees. This paper is concerned particularly with management options for executives and executive directors, and to a much lesser extent with employee options. It will be convenient to refer to directors' share options as DSOs, to executive share options as ESOs (which include DSOs) and to staff share options generally (comprising both ESOs and employee options) as SSOs.

Major influences in encouraging UK SSOs were the Finance Acts of 1980 and 1984, which relieved schemes from income tax if certain requirements were met. The tax effects have been modified by subsequent legislation, but remain advantageous. However, for the *employing company* the tax treatment of SSOs depends crucially upon the method by which shares are provided on exercise. Exercise can be satisfied either by allowing the grantee to *subscribe to new shares* or by the provision of *existing shares* (normally purchased via a trust), with different effects for both disclosure and taxation.

SSOs are a form of reward. Share options may, or may not, have special incentive effects in aligning staff, and particularly management, interests with the welfare of the company. Such incentive effects[1] are not at issue in this paper, which is concerned with the alternative costs of providing rewards and with the disclosure implications of these alternatives.

Managers are rewarded as agents of shareholders, and the granting of ESOs raises issues on corporate governance[2] and levels of disclosure. The Companies Act 1985 requires disclosure of options, but it will be seen that those requirements have an erratic coverage. For reasons which are probably accidental, the most tax-effective methods of satisfying options are in fact subject to the least disclosure. Whether monitoring should be extended, particularly for disclosure of directors' options as advocated by the Institutional Shareholders' Committee (ISC, 1991, p. 5), will be considered. But before examining disclosure the costs of options under the UK tax regime will be reviewed.

Tax and share option rewards

Employee option schemes have been eligible for Inland Revenue approval since the Finance Act 1980 and ESO schemes since 1984. Our focus will be on the latter as they involve managerial decision-makers and are normally for much larger sums which are financially important to the individuals concerned. A major benefit of an approved

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[1]Among recent considerations of incentive issues are Bruce *et al.* (1989), Egginton *et al.* (1989) and Jensen and Murphy (1990).

[2]See Forker (1992) for an empirical model of the option disclosure decisions of management.

scheme is a delay in tax liability; originally there was also a benefit from being taxed at the lower capital gains rate, when that rate differed from the marginal income tax rate. The grantee of a right to acquire shares under an approved scheme is taxed on any capital gain made when shares are *sold*, whereas a grant under an 'unapproved' scheme would be liable for income tax on the difference between the market and exercise price when the option is *exercised*.[3] Capital gains are now taxed at the taxpayer's marginal income tax rate but there remains a benefit from the capital gains annual exemption limit (of £5,800 in 1993/94) which reduces the *average* rate paid on capital gains.

Among the requirements for approval of a scheme is a restriction on the exercise price.[4] Since 1990 the exercise price can be a maximum of 15% below the market price at the date of granting an ESO; previously approved schemes could not have an exercise price below market price. However, the potential for discounts does not affect the ranking of alternatives in the analysis of tax effects.

There are complex implications for the shareholders who fund the ESOs. The cost of an option must be compared with that of a conventional reward, which for comparison purposes can be assumed to be a bonus payment. There are also two ways of providing shares to satisfy an option[5] which bring different tax consequences. Thus for shareholders faced with offering an incentive 'payment' for future performance, the choices split three ways:

(A) Offer a bonus, which will be deductible for corporation tax.

(B) Offer a share option to be satisfied on exercise by the issue of new shares. The new shares will have dilution effects on the future returns available to shareholders, but will not be deductible for corporation tax.

(C) Offer a share option to be satisfied on exercise by existing shares. These shares may be held in trust, or in appropriate circumstances they may be bought via intermediaries. There will not be any dilution effects, and the cost of the shares will be deductible for corporation tax.

For the purposes of comparison it will be assumed that 'payment' occurs at the same time in all cases. Thus, at that time, achieved performance is observable so that either a bonus payment becomes payable or executives find it worthwhile to exercise their options, depending on the reward vehicle chosen for the company.

In the absence of taxation the cost to the company of rewarding the manager with an equal amount under each of the three methods would be identical. The bonus (Case A) would require a straight cash payment. That payment would be equal to the net cost of an option satisfied by purchase of existing shares in Case C, where the purchase cost would be partially offset by the exercise price received from the manager. In Case B the issue of new shares will, by dilution, reduce the value of the original shares by the present value of the stream of cash flows (dividends and any terminal value) to the holders of the new shares – which equals the current market value of those shares. Consequently the dilution cost to the original shareholders is identical to that for purchase of existing shares, and again that cost is partially offset by the exercise price received from the manager. Thus a bonus payment, the purchase of existing shares or the issue of an equivalent value of new shares would all have the same cost to the company. However, that is not the case in the presence of taxation.

The tax consequences of the three alternative approaches will be demonstrated by developing a simple model. It will be assumed that a manager is to be rewarded with an after-tax amount which is constant in each of the three cases. By holding the after-tax payment to the manager constant regardless of the method of reward, it will be possible to rank the preferences of shareholders over the three alternatives by comparing the aggregate value of the company to the (original) shareholders in each case. The most tax efficient procedure is the one that gives the highest value of the company to those shareholders.

The following notation will be adopted:

t_b = rate of imputation on dividend distributions,
t_c = rate of corporation tax,
t_s = average of the marginal rates of tax of shareholders trading at the margin in the market,[6]
t_g = manager's average rate of capital gains tax paid on gains from the options,[7]
t_m = manager's marginal rate of income tax,
Y = present value of the company's (= shareholders') future pre-tax cash flows,
P = total value of shares the manager receives,
X = total exercise price the manager pays for shares received,

[3]Readers accustomed to regarding options as valuable rights will consider that the receipt of a benefit by an executive occurs when the option is granted. That issue is developed in the disclosure context of the next section.

[4]For full consideration of Inland Revenue requirements and institutional investor guidelines, see Pett and Moss (1989).

[5]It is, of course, necessary to ensure that the terms of the particular scheme permit servicing by the chosen method.

[6]It is the after-tax value to marginal shareholders that determines the price of shares in the market.

[7]The rate of capital gains tax is the figure after appropriate adjustments to take account of any time that elapses between exercise and when the shares are sold.

V_A = aggregate value of the company if manager is rewarded by a bonus,

V_B = aggregate value of the original shares in the company (excluding those issued to the manager) after new shares are created to meet obligations to the manager on exercise of a share option,

V_c = aggregate value of the company after existing shares are purchased to meet obligations to the manager on exercise of a share option,

S = bonus addition to salary,

i = employer's national insurance contribution on bonus.

We begin by considering Case C, where shares are bought to meet obligations to the manager. Existing shares are purchased for a value of P and used to service options exercised in exchange for an exercise price of X. Let the fraction of the company's shares purchased to service these obligations be α. V_c is the aggregate value of the company, so the cost of the α shares in the market is αV_c. The remaining shares will have the fraction $(1-\alpha)$ of future cash flows. Thus V_c must satisfy the relationship:

$$V_c = \alpha V_c + (1-\alpha)\frac{(1-t_c)(1-t_s)}{(1-t_b)} \times (Y-(P-X)) \quad (1)$$

giving:

$$V_c = \frac{(1-t_c)(1-t_s)}{(1-t_b)}(Y-(P-X)) \quad (2)$$

The tax term $(1-t_c)(1-t_s)/(1-t_b)$ reflects the imputation system, whereby those distributions to shareholders which have been subjected to UK corporation tax at rate t_c are imputed to have borne income tax at a rate t_b and are liable to the shareholder's personal rate of income tax (at the average rates for the marginal shareholder t_s).[8]

Case B can now be considered, where new shares are issued to satisfy the option on exercise. Here the aggregate value of the company after receipt of the exercise price X (which is assumed to augment the value of the company by X) is:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}Y + X \quad (3)$$

The sum of the post-dilution value of the original shareholders' interest in the company, V_B, and the manager's shares P must be equal to the value of the company in (3), i.e.

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}Y + X = V_B + P \quad (4)$$

[8]For more extensive consideration of the implications of the imputation system for valuation see Ashton (1989).

It follows from (2) and (4) that V_c is greater than V_B if:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}(Y-(P-X)) > \frac{(1-t_c)(1-t_s)}{(1-t_b)}Y-(P-X) \quad (5)$$

giving:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}(P-X) < (P-X) \quad (6)$$

Thus V_C is greater than V_B if the net after-tax cost of satisfying the option via purchase of existing shares in Case C (left hand side of (6)) is lower than the net cost of issuing new shares in case B (right hand side of (6)). This holds if the tax term $(1-t_c)(1-t_s)/(1-t_b)$ is less than unity, which is the case if there are benefits to companies in claiming costs against taxable corporate income. A formal consideration of the value of the tax term $(1-t_c)(1-t_s)/(1-t_b)$ follows.

An imputation system is based on the principle that income tax at some specified rate is imputed to have been paid provided corporation tax has been borne on the relevant income. Thus t_c must either exceed or equal t_b, otherwise tax authorities would be refunding tax (via the imputed tax credit) which had not been paid. Consequently:

$$t_c \geqslant t_b \quad \text{and} \quad \frac{(1-t_c)}{(1-t_b)} \leqslant 1 \quad (7)$$

With regard to the value of t_s, marginal shareholders either pay tax or are exempt from tax, so that $(1-t_s) \leqslant 1$ and therefore:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)} \leqslant 1 \quad (8)$$

Thus it follows that $V_C \geqslant V_B$, so that options to subscribe to new shares can never be more tax-effective than options satisfied by existing shares. Moreover the prospect of simultaneous values of $t_c = t_b$ and $t_s = 0$ are so remote (the former has never occurred for large companies so far in the UK tax regime) that $V_C = V_B$ can be ignored for practical purposes. Thus for policy purposes $V_C > V_B$, so that tax considerations favour those options which can be satisfied by the purchase of existing shares.

The purchase of existing shares can now be compared with case A, where the manager is rewarded by the payment of a bonus addition to salary. Consideration of national insurance contributions will be deferred until later. Denoting the bonus payment by S, which is deductible for corporation tax purposes, the value of the company becomes:

$$V_A = \frac{(1-t_c)(1-t_s)}{(1-t_b)}(Y-S) \quad (9)$$

Then the after-tax payment to the manager is constant when:

$$(1-t_m)S=(1-t_g)(P-X) \quad (10)$$

so that:

$$S=\frac{(1-t_g)}{(1-t_m)}(P-X) \quad (11)$$

where t_m is the manager's marginal rate of income tax and t_g is the average rate of capital gains tax paid by the manager on gains from the option. V_C is greater than V_A if:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}(Y-(P-X)) > \frac{(1-t_c)(1-t_s)}{(1-t_b)}(Y-S) \quad (12)$$

Using (11) to substitute for S in (12) gives:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}(Y-(P-X)) > \frac{(1-t_c)(1-t_s)}{(1-t_b)}\left(Y-(P-X)\frac{(1-t_g)}{(1-t_m)}\right) \quad (13)$$

which holds if $t_g<t_m$. Thus options satisfied by purchase of existing shares are superior to a bonus payment if the average capital gains tax rate paid on the gain is less than the manager's marginal rate of tax. The reason is that purchase allows $P-X$ to be offset against tax in the same way as the bonus, S, so that the issue is then determined by the manager's tax position.

Currently in the UK capital gains above a certain threshold are taxed at the taxpayer's marginal rate of tax. The operation of the threshold reduces the *average* tax rate on capital gains, t_g, below the marginal rate of income tax. Consequently $t_g<t_m$, if the manager does not have other capital gains exceeding the threshold in the year the gains are realised. Only where the threshold allowance had been exhausted by other capital gains would $t_g=t_m$, and it has to be borne in mind that the manager has some flexibility in choosing the timing for realisation of gains. Thus although formally $(1-t_g)/(1-t_m)\geqslant 1$ and $V_C\geqslant V_A$, for company policy purposes in relation to most managers $V_C>V_A$.

Coming now to the comparison of a bonus with a share issue, $V_B>V_A$ if:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}Y-(P-X) > \frac{(1-t_c)(1-t_s)}{(1-t_b)}(Y-S) \quad (14)$$

Using (11) again to substitute for S, (14) becomes:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}Y-(P-X) > \frac{(1-t_c)(1-t_s)}{(1-t_b)}\left(Y-(P-X)\frac{(1-t_g)}{(1-t_m)}\right) \quad (15)$$

The inequality in (15) would hold true if:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}\cdot\frac{(1-t_g)}{(1-t_m)}>1 \quad (16)$$

However, with $(1-t_c)(1-t_s)/(1-t_b)\leqslant 1$ and $(1-t_g)/(1-t_m)\geqslant 1$ it can only be said that $V_B \gtrless V_A$ according to the relativities of the tax rates.

National insurance payments can now be considered. It will be assumed that managers will not be liable for employee contributions on the bonus, which means that either the manager is contracted out from Class 1 contributions or is already receiving a salary in excess of the top contribution level. The employer's national insurance contribution, i, is taken as proportional to the bonus, so that the gross cost of a bonus becomes $S(1+i)$. This affects only V_A, as the employee benefits under cases B and C are not liable to national insurance. Thus the amendment needs to be considered in comparing V_C with V_A and V_B with V_A.

Reconsidering V_C with V_A, (13) becomes:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}(Y-(P-X)) > \frac{(1-t_c)(1-t_s)}{(1-t_b)} \times\left(Y-(P-X)\frac{(1-t_g)}{(1-t_m)}(1+i)\right) \quad (17)$$

The national insurance cost increases the previous advantage of V_C over V_A, so that the company policy prescription of $V_C>V_A$ is reinforced.

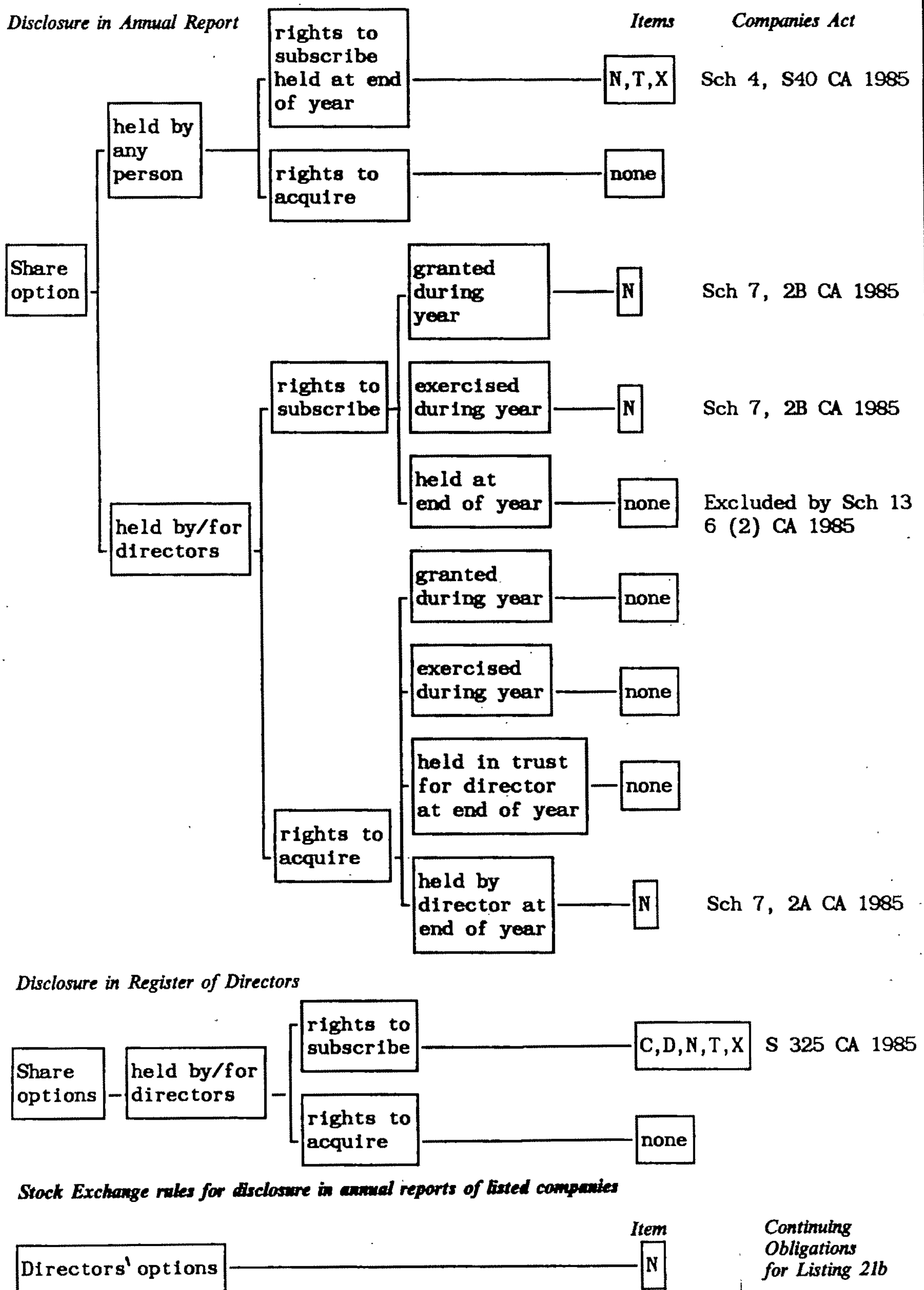
In the comparison of V_B with V_A, (15) becomes:

$$\frac{(1-t_c)(1-t_s)}{(1-t_b)}Y-(P-X) > \frac{(1-t_c)(1-t_s)}{(1-t_b)} \times\left(Y-(P-X)\frac{(1-t_g)}{(1-t_m)}(1+i)\right) \quad (18)$$

Now the direction of the inequality depends on the relationship between $(1-t_c)(1-t_s)/(1-t_b)$ and $((1-t_g)(1+i))/(1-t_m)$. Although the presence of i will reduce V_A it is still not possible to specify the direction the inequality will take in the absence of specific rates (and t_s is particularly difficult to estimate). Consequently it remains the case that $V_B \lesseqgtr V_A$.

Figure 1
UK Disclosure Requirements on Options

Statutory requirements



To summarise, it can be concluded that $V_C > V_B \geqslant V_A$. The grant of options which are satisfied by the purchase of existing shares is therefore more tax effective than either options involving issue of shares or the payment of a bonus.

UK disclosure requirements

In view of the alternative methods of satisfying options and the tax bias towards the use of existing shares, it may seem surprising that UK statutory disclosure requirements on options are concerned largely with rights to *subscribe* to shares. This emphasis seems to arise from a preoccupation with the disclosure of potential dilution of shareholders' equity, rather than with rewards to management or employees *per se*. The grant of rights to *acquire* shares (which can be satisfied from existing shares) need only be disclosed under the Companies Acts in very rare circumstances.

The current UK disclosure requirements in relation to options are set out in Figure 1. The following notation is used for disclosure items:

C = the consideration (if any) given by the grantee for the option,
D = date the option was granted,
N = number of options,
T = the time period for the exercise of the option, and
X = the exercise price for the option.

It can be seen from Figure 1 that the major Companies Act provision (Sch. 4, para. 40, CA 1985) requires X, N and T to be disclosed for rights to *subscribe* held by any person at the end of the year. The provision does not apply to the wider *rights to acquire*. Movements of N have to be disclosed for directors only for rights to *subscribe* granted and exercised during the year (Sch. 7, para. 2B, CA 1985).

Byzantine rules apply to the disclosure of directors' options held at the end of a year. There is a requirement in Sch. 7, para. 2A (1) that a director's interests in shares at the end of the year should be disclosed. However, Sch. 7, para. 2A (4) goes on to say that an interest in shares shall have the same meaning as in S. 324 of the Act. The interpretation rules for S. 324–328 are set out in Sch. 13, where para. 6 (2) excludes rights to *subscribe* – perhaps because the interpretation rules were mainly directed at 'concert parties' for takeover bids (introduced in the Companies Act 1981) rather than share option schemes. The (unintentional?) consequence is that directors' rights to *subscribe* held at the end of the year are not disclosable, but rights to *acquire* which are held by a director remain disclosable under Sch. 7, para. 2A.

In practice rights to *acquire* shares will normally be held in trust for a director, and so would not be disclosable. Consequently in one way or another options held by or for a director at the end of a year are rarely disclosable under the Companies Act.

The Stock Exchange has a more robust approach, which was introduced to plug the legislative gaps. Listed companies have to disclose in their annual accounts the number of shares held under option by directors, without regard to whether the options are to subscribe or acquire. However, disclosure is restricted to N. For the Register of Directors, the Companies Act requires its fullest disclosure, of all the items C, D, N, T and X. But again the requirement is restricted to rights to *subscribe*.

Thus Companies Act disclosure is overwhelmingly directed at options to subscribe to new shares. Options rights to acquire existing shares, which were suggested earlier to be cheaper for tax reasons, can escape statutory disclosure (although not the Stock Exchange rule on the number of directors' options). It might seem that the combination of cheapness and minimal disclosure should be irresistible to companies, making rights to acquire the predominant method. Paradoxically the evidence to be considered in the next section suggests the opposite.

UK option practices

Option disclosures were examined in the annual reports of 200 UK companies. The reports were for accounting periods ending between October 1987 and October 1988 for the largest 100 and smallest 100 UK listed companies in the 1988–89 *Times 1000*. Three of the largest companies and 15 of the smallest companies did not have option schemes, reducing the sample to 182 in total. Table 1 shows disclosures on options to subscribe to shares. Shares to satisfy options to subscribe had been issued by 61% of the sample companies, and a further 18% disclosed options carrying the right to subscribe to shares. Thus at least 79% had adopted options of the subscription type – probably the more

Table 1
Options to Subscribe to Shares

	%
Companies disclosing issues of shares to service options in the accounting period	61
Companies disclosing options involving rights to subscribe to shares, but without issues of shares to service the options in the accounting period	18
Companies with option schemes which did not disclose information on either the issue of shares to satisfy options or rights to subscribe to shares	21
	100

expensive method, with more onerous disclosure requirements. Companies may adopt different methods for different schemes, so that all the 79% of companies using options to subscribe in Table 1 could conceivably also have issued options to acquire shares. However, it remains the case that most companies adopted the more expensive method for at least one scheme.

A likely explanation for the popularity of options to subscribe lies in the fact that they do not give rise to a charge against the profit and loss account. In contrast the financing of options to acquire existing shares involves a cost which reduces reported profits, and thus earnings per share (EPS). Certainly this is an issue which receives attention from professional advisers and is noted in the professional literature (see Pett and Moss, 1989, pp. 47–48).

That the avoidance of a charge against profit apparently determines the adoption of the more expensive method raises an important issue of corporate governance. In such circumstances shareholders are never made explicitly aware of the reduction in their wealth which occurs when options are exercised, so that they are less likely to question the benefits derived. Similarly managers are not explicitly confronted with the costs imposed on shareholders, so that excessive issue of options is more likely to occur. The minimisation of shareholder surveillance or a connected belief that the stockmarket is functionally fixated on the earnings number[9] presumably motivates the desire to avoid the charge against profit. Yet the original shareholders forgo value by dilution just as surely as if a cash payment had been made. A possible solution to the corporate governance issue would be for accounting standards to require a charge to be disclosed in the profit and loss acount irrespective of the method of satisfying executive options. In the case of share issue the difference between the market value of the issue and the exercise price could be debited to profit and loss and credited to reserves, symbolising the funding of executive remuneration by shareholders. Such an approach would assist in the operation of corporate governance; it could also lead more companies to adopt the tax effective share purchase route.

Despite the popularity of the subscription method with its higher disclosure requirements, the disclosure by the sample companies was very patchy. Table 2 shows the range of disclosure from those companies which gave the statutory maximum (X, N and T) to those that gave the minimum (N) required by the Stock Exchange Listing Agreement.

Maximum disclosure (of X, N and T) would be required for rights to subscribe held at the end of

Table 2
Disclosures on X, N and T

	Directors' holdings		*All participants*	
	Top 100	*Bottom 100*	*Top 100*	*Bottom 100*
	%	%	%	%
X, N, T	5	15	40	52
Intermediate disclosure	22	10	58	44
N only	73	75	2	4
	100	100	100	100

an accounting period (Sch. 4, para. 40 CA 1985 – see Figure 1). Disclosure on this item is shown in Table 2 to range from a low of 5% for directors' share options in the largest companies, to a high of 52% for options to all participants for the smaller companies of the sample. Yet Table 1 showed that 79% of companies adopted options to subscribe. Thus there is an implication that many companies were not making the degree of disclosure required by law.

At the other end of the scale, 73% of the largest and 75% of the smaller companies disclosed only the Stock Exchange minimum of N for DSOs. In contrast very few companies (2% and 4%) restricted data to such a minimal level for options involving all participants. It is possible, if unlikely, that the large difference arises purely because the DSOs were predominantly rights to acquire held in trust (and therefore outside the statutory disclosure rules). An alternative explanation would be that fuller information was disclosed on employee options (open to all participants) for employee relations motives.

A framework for regulating managerial options disclosure

The preceding sections have shown UK option disclosure requirements and practices to be haphazard. A contributory factor to this may be the ambivalence of UK legislation on management rewards, which requires limited shareholder involvement and patchy disclosure.

The rules requiring annual shareholder approval of the appointment and remuneration of auditors (SS. 385 and 390A, CA 85) contrast with those applying to directors, and particularly executive directors. Although the model articles in Table A (CA 85, art. 82) refer to remuneration being set by resolution of the company, that is confined to what are normally termed directors' *fees*, and companies are, of course, free to amend the provisions of Table A. On the management role and remuneration of *executive* directors article 84 states: 'Any such appointment, agreement or arrangement

[9]The issue of functional fixation, with its implications of stockmarket inefficiency, has recently been the subject of renewed debate in Hand (1990, 1991) and Ball and Kothari (1991).

[for appointments to executive office] may be made upon such terms as the directors determine and they may remunerate any such director for his services as they think fit'. Moreover executive directors do not submit to re-election by rotation (Table A, art. 84). However, contracts exceeding five years must be approved by shareholders (S. 319, CA 85), service contracts must be open to inspection (S. 318) and emoluments must be disclosed (S. 232 and Schedule 6) although identified to an individual only in the case of the Chairman.

It could be argued that any such regulation concerning management remuneration is unnecessary. Such a view assumes that appointment and remuneration of directors will be regulated by the managerial labour market. Fama (1980) considers how the wage revision process (*ex post* settling up) could discipline management, and Benston (1982) argues that, through self-interest, management 'will voluntarily tend to publish the accounting data that maximise the wealth of the shareholders' (p. 9). However, Fama recognises limitations of labour market discipline (e.g. when a manager does not expect to be in the labour market for many future periods) and makes the disclaimer that 'No claim is made that the wage revision process always results in a full *ex post* settling up on the part of the manager' (p. 306). Benston also concedes 'some role for accounting standards with respect to corporate governance' (p. 12). Fama and Jensen (1983, p. 315) see non-executive directors as arbiters of executive compensation, hypothesising that such outside directors have incentives to signal their expertise, but they also point to circumstances in which such control can break down. Thus even strong advocates of market discipline recognise that market failures in the area of management rewards give rise to a need for at least some minimal regulation of disclosure.

Given the market failure justification for disclosure, which is implicitly accepted in UK legislation by some disclosure of directors' rewards, what minimum information is needed for shareholders to assess the rewards that management receives from ESOs? An apparently simple answer is that shareholders should know the value of the ESOs, but that begs two further questions:

1. Should disclosure on value relate to the grant-date of an ESO, to the vesting-date at which the executive can first acquire the shares covered by the option, or to the exercise-date?
2. Should a value be provided or should information be given to allow the user to calculate a value?

On the first question, full awareness of the costs of management rewards at different stages would require information at all three dates for full disclosure. But of the three, information at the grant-date is the most important, since that shows the *ex ante* commitment of the company and allows both existing and potential investors to assess the potential impact on the company.[10] However, information at vesting-date and exercise-date allows for an *ex post* assessment of management rewards relative to achievement, and could contribute to the *ex post* settling up process.

It is usual to assume a zero value at grant-date for the standard ESO for which exercise price is the same as the grant-date market price. In the UK both tax rules and generally accepted accounting practice assign a value at grant-date only to the extent that current market price exceeds the future exercise price.[11] Yet an ESO is similar to a call option on the company's shares (Noreen and Wolfson, 1981), call options are traded for value, and Black and Scholes (1973) and subsequent developments in option-pricing theory provide a structure for estimating option values.

There are genuine difficulties in valuing an ESO at grant-date. In particular, an ESO is not transferable and would be forfeited if the executive left the company, so that an ESO is not tradeable. But value can be estimated (e.g. see the empirical study by Foster, Koogler and Vickrey, 1991) and in the broadly similar case of pensions costs there are standard procedures for disclosure.

However, the required assumptions for ESO valuation[12] are such that UK disclosure to allow the user to reach a value would be much less controversial. Since the basic information required is relatively simple (as opposed to the choice of model and accompanying assumptions), disclosure would not be costly. Moreover, if a straight choice had to be made between disclosure of the raw data or an estimated cost of option-based rewards, the shareholders (or their financial advisers) would be more fully informed by the former. The additional disclosure of an estimated cost of option-based rewards can still remain a valid longer term disclosure objective.

The estimation of value of ESOs can be approached with the aid of the Black and Scholes (1973) option pricing model. Using the notation of Copeland and Weston (1988, p. 268) the value of a

[10] Foster *et al.* (1991) support the use of grant-date value information on the somewhat different grounds that they consider it to be consistent with option-pricing theory. Their research also suggests that grant-date accounting would be less costly than vesting-date accounting and would involve no loss of information (p. 609).

[11] Arthur Young (1989, p. 954) state: 'A... widely accepted basis of determination... is that the benefit should be valued as the difference between the mid-market price of the shares at the date the option is granted, and the price at which the shares may be acquired under the terms of the option'.

[12] The US experience is instructive. Proposals for grant-date valuation (FASB, 1981) were replaced by proposals for vesting-date valuation (Swieringa, 1987) but a valuation method has yet to be adopted.

call option, c, is given by:

$$c = SN(d_1) - X\,e^{-r_f t}N(d_2)$$

where:

- c is the value of a a European call option (i.e. can only be exercised on maturity),
- S is the share price at valuation of the option,
- t is time to maturity of the option,
- X is the exercise price,
- $N(d)$ is the cumulative normal density function, and

$$d_1 = \frac{\ln(S/X) + r_f t}{\sigma\sqrt{t}} + \tfrac{1}{2}\sigma\sqrt{t}$$

$$d_2 = d_1 - \sigma\sqrt{t}$$

where σ is the standard deviation of the continuously compounded annual rate of return on the share.

The model can be modified to employ additional assumptions, particularly with regard to the assumed stream of dividends (Merton, 1973; Foster, Koogler and Vickrey, 1991). But the important implication for disclosure purposes is that the Black-Scholes model shows the central data requirements to be S, t, X and σ. The valuer can develop an estimate of σ and add further modifications and assumptions as desired.

Thus the three basic pieces of information needed to estimate grant-date value of a single option are S, t, X. The first of these can be determined from market data if the date (D) of granting the option is known. The second (for grant-date value) is given by the time period (T) for exercise of the option. Thus when D, T and X are known, there is a basis for estimating the value of a single option. Someone who wanted to estimate the value of a number of options would also need to know N, the number of shares over which options were granted. Furthermore it is possible, if unusual in the case of management options, that some consideration (C) might be paid in exchange for granting the options.

Thus it can be said that a full information set which would allow investors or their advisers to estimate the net value of options granted would be C, D, N, T and X. That is precisely the set of information shown in Figure 1 as required for the Register of Directors, but for rights to *subscribe* only. Access to the Register of Directors is cumbersome and the restriction to rights to *subscribe* is outmoded. It is our view that movements on all those data items, reconciled to end of year options held, should be required for annual reports, irrespective of whether rights to acquire or subscribe are involved. One international audit firm also sees such information as desirable. Moreover the information is not excessively lengthy and the firm illustrates a relatively simple data summary in one of its publications.[13]

Conclusions

The existing UK statutory requirements on options do not have any coherence on disclosure of options. The minimal disclosure requirements for options which can be satisfied by existing shares contrasts strangely with the tax advantages of that route. The paucity of information on exercise prices of options is also surprising in the context of the recent tax concession which allows an exercise price to be set as far as 15% below market price.

There has been concern in the investment community that UK companies should pay greater attention to their corporate governance procedures, and in particular that the forms of rewards for directors should be more transparent. This concern is evidenced in the ISC (1991) Statement of Best Practice.

In very broad terms the ISC disclosure which would cover director ESOs is consistent with the views in this paper:

> A summary of the details of any performance-linked remuneration schemes and of all types of share option and other incentive and profit sharing and bonus schemes should be included in the Annual Report. (p. 5)

However, as far as options in general are concerned, some minor amendments to the Companies Act would ensure disclosure rather than having the matter left to the doubtful pressures of 'best practice'. Moreover, as the earlier analysis in this paper showed, there is no need to be as vague as the ISC on content; the data requirements are both specific and inexpensive.

The requirements could be satisfied by a disclosure table similar to that adopted for movements in fixed assets. Disclosure would be required for all rights of executives to *acquire* shares (irrespective of whether the options are to be satisfied by existing shares or subscription to new shares). The options granted, exercised and lapsed during the year could be shown with the appropriate data items (C, D, N, T, X) for each director, together with a total amount for non-director options. This relatively minor change in the law would remedy the currently confused state of option disclosure in the UK.

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[13] Arthur Andersen (1990, p. 162) state: 'In our view, where no amount is included in directors' emoluments for the value of options, sufficient information should be provided for each director's options, and for other employee options in aggregate, for the informed user of accounts to calculate alternative reasonable values for the options'. The document goes on to provide an example.

Another aid to improved governance, which was touched upon earlier in this paper, would be the appearance of charges in the profit and loss account of listed companies to show the net costs of satisfying the exercise of director and non-director options. At present a charge would be made against profit under the purchase method but the amount may not be disclosed separately, and the dilution arising from share issue does not affect profit at all. The suggested accounting treatment for the share issue method would involve a debit to the profit and loss account and a credit to reserves. Thus the profit and loss account could reveal the costs of options borne by shareholders and the corresponding rewards received by directors and non-directors. Such a development in disclosure practice would not necessarily need legislation but might be initiated through an accounting standard.

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Executive Compensation and Deregulation in UK Building Societies

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Abstract—Herein we examine executive compensation in UK building societies in two differing regulatory regimes: (a) in a weakly competitive environment, and (b) in conditions of increased competition. Our results show that the change in regulation did affect the manner in which CEOs in building societies were remunerated. In particular, when there is little external competition, profitability does not positively influence compensation. However, when this external competition increases, improvements in profitability lead to subsequent increases in CEO remuneration. Our work supports the contention that mutuality can be efficient when operating in a sufficiently competitive environment.

Introduction

The corporate governance literature—including contributions in this issue by Forbes and Watson (1993), Mangell and Singh (1993) and Main and Johnston (1993)—contains much investigation of the sensitivity of executive compensation to firm performance.[1] The managerial remuneration contract is clearly a potentially important mechanism for aligning the interests of owner-principals and manager-agents and thereby reducing the problems arising from divergent ownership and control, although it is widely recognised that difficulties in observing individual effort levels and output contributions create problems in designing pay structures (Rosen, 1992). The present paper differs from almost all the previous empirical literature by examining managerial pay determination among financial mutuals. Specifically, it investigates compensation determination across a period of regulatory change to consider whether a more competitive environment produces a switch to more performance-related executive remuneration. In so doing, the paper examines the ability of the mutual form of business organisation to solve agency problems associated with an absence of conventional residual claimants.

In the joint stock form of business organisation the typical agency problem is that of a dispersed set of shareowners confronting a group of salaried managers. Following Jensen and Meckling (1976) it may be expected that managerial behaviour will become distorted in the direction of preferred expenditures or preferred activities as the proportion of outside equity increases. This introduces agency costs: monitoring by owners, bonding by managers and those residual costs of potentially useful relationships that are not worth undertaking because of governance problems. Devices such as executive compensation committees, stock options, and profit bonuses may be considered as means of motivating managers to act in a value-maximising fashion.

In contrast to the shareholder-owned public company, the financial mutual is nominally controlled by its owner-members: depositors in building societies and 'with profits' policyholders in insurance companies. However, while the financial mutual has the potential to create value (i.e. to sell its services for more than their cost of provision) any residual generated accrues to all the members, but they can neither appropriate it nor transfer it. This has been considered to attenuate the incentives for members to participate in the governance of mutuals (Barnes, 1984; O'Hara, 1981), particularly in monitoring the performance of any mutual's management. However, the resulting scope for rent-seeking by managers depends critically upon market imperfections in the mutual's competitive environment. Under competitive market conditions the mutual managers may be constrained to act in a similar manner to their public company equivalents.

This paper investigates the impact of deregulation—and the resulting change in competitive regime—upon chief executive officer (CEO) compensation among a sample of 52 UK building societies over the period 1987 to 1989. Our econometric work takes two routes. Firstly, we employ cross-sectional data to investigate the determinants of executive compensation across regulatory

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[1] A comprehensive review of the recent literature is given in Rosen (1992).

regimes. The robustness, or otherwise, of the parameter estimates in the two data periods serves as an indicator of the impact of regulatory change. Our results suggest that, in a weakly competitive environment, performance did not affect CEO remuneration. In the later data period, in a more competitive environment, our results support the idea that increases in profitability positively affect remuneration levels. Our results did, however, suggest severe parameter instability across the two cross-sections. We therefore extend our empirical analysis to include panel data estimation wherein certain parameters exhibit time dependence. With this procedure, we demonstrate the shifting relationship between certain performance measures and executive compensation over time. In particular the emergence of a positive pay/profitability relationship is noted.

We begin by examining mutuality and the particular problems that this poses for effective corporate governance, and also by discussing the degree to which traditional performance indicators reflect the goals of mutual organisations. Then a section considers regulatory reform in the UK and the effect that this has had on competition within the financial services sector. Thus we examine how changes in external control mechanisms may have affected managerial behaviour within the societies. The factors which we conjecture will determine an individual CEO's compensation are discussed and tested in a further section.

Mutuality and performance

All UK building societies are, by definition, mutuals and are owned by their members.[2] The sector has its origins as far back as the mid-eighteenth century when societies were established to finance members' house purchases. In the early days societies were 'terminating' in the sense that their constitutions ensured their extinction once all members' houses were paid for. It was not until the middle of the nineteenth century that the first 'permanent' society was formed; these societies have constitutions which allow them, *ceteris paribus*, to continue their operations indefinitely (see Drake, 1989). All terminating societies have now ceased trading and thus the sector comprises exclusively permanent societies.

There are two peculiar features of the ownership structure of UK building societies: the first is the dispersion of the ownership claims on the basis of one member, one vote. This precludes the purchase of any degree of control in the enterprise. In this respect the sector differs from its US counterpart, the mutual Savings and Loans, since in these institutions members may hold up to 50 votes depending upon their financial stake (see, for example, O'Hara, 1981). Secondly, UK ownership claims are non-exclusive and non-marketable: a new society member typically enjoys identical rights to existing members.[3] Hence property rights over any residual are ineffectively exercised by individual owners—there is, in effect, an absence of residual claimants.

Building societies are, therefore, effectively owned by their customers. In the context of the US insurance industry, Mayers and Smith (1981) note that customer (i.e. policyholder) ownership simplifies agency relationships in that it eliminates the customer/owner conflict of stock insurance companies. However, in the context of UK building societies, ownership by customers sometimes creates an additional conflict of interest, since the customer group may be defined to include both borrowers and lenders. By definition, therefore, any measure designed to benefit one sub-set of the customer group will necessarily be harmful to others. Raising interest rates, for example, will benefit lenders but penalise borrowers.

Returning to the relationship between owners and managers, it is clear that the restricted property rights of the former have strong implications for the governance of the agency relationship itself. First, the internal governance provided by member participation and voting in annual general meetings, etc is severely weakened by an obvious free rider problem: the expected individual benefit from such monitoring activities will be vastly exceeded by their costs.[4] Second, mutual ownership effectively protects societies from hostile takeovers thus removing an important external constraint on managerial behaviour.[5]

Some researchers (e.g. Barnes, 1984; O'Hara, 1981) have concluded that the attenuated ownership rights of mutuals' members leave the firm's managers in a particularly strong position to engage in rent seeking activities. However, there are theoretical, regulatory and market-based constraints which continue to apply. First, as Fama and Jensen (1983a, b) point out, the seemingly weak owner control is partially counterbalanced by the ease of redeeming the financial liabilities of the mutuals:

[2]Although the 1987 Building Societies Act made provision for demutualisation, once a society chooses this option it becomes a bank and its regulation is transferred to the Bank of England. Thus far only one society, the Abbey National, has taken this route although several others have actively considered this option.

[3]This contrasts with mutual organisations such as golf or tennis clubs, where new members are generally required to pay a joining fee in recognition of the past accumulation of facilities.

[4]The only recent example of high attendance and of pressure group action by a sub-set of members concerned the demutualisation of the Abbey National.

[5]For a building society to be subject to a hostile takeover it would need to demutualise.

> the unique characteristic of the residual claims of mutuals is that they are redeemable on demand. The policyholder, depositor, or shareholder can, on demand, turn in his claim at a price determined by a pre-specified rule. ... The decision of the claim holder to withdraw resources is a form of partial takeover or liquidation which deprives management of control over assets. (Fama and Jensen, 1983a, p. 317)

Of course the cost of exercising this option is frequently non-zero, and for certain customer groups can be substantial. Within insurance companies, for example, early redemption of long term policies is greatly penalised, thus imposing a large withdrawal cost on a customer wishing to liquidate his claim. In the case of building societies, higher interest rates are paid to members who are willing to commit their resources for long periods and certain accounts attract penalty loss of interest if withdrawals are made within a statutory notice period. Additionally there are normally non-trivial switching costs associated with the transfer of a mortgage from one lender to another. These measures serve to limit the mobility of members' assets and liabilities and thereby weaken the power of immediate redemption as a control mechanism on managers.

Secondly, despite the relaxation of controls which came in the 1986 Building Societies Act, the sector remains subject to regulation by the Building Societies Commissioner, whose major objective is to ensure financial probity so that the public considers building society deposits to be near zero-risk assets. To this end, regulation has generally focused on liquidity, and societies facing an illiquid asset structure—perhaps following a period of extraordinary withdrawals—or those experiencing an operating loss may find that the Commission 'recommends' their acquisition by another society. Thus even though, as noted above, societies are protected from takeover outwith the sector, they still face possible acquisition at the behest of the Commissioner if they experience financial difficulties.

Finally, an extensive literature[6] in the US, using both the S&L and insurance industries, has failed to produce an unequivocal case that joint stock companies outperform their mutual rivals. In general, this work finds no significant differences between the two forms when both operate within competitive markets. However, in highly concentrated and/or regulated markets the mutuals may exhibit inefficiency. Thus it is not mutuality *per se* which appears inefficient but rather mutuality coupled with market imperfections (Llewellyn and Holmes, 1991). It is to this that we now turn.

Competition and deregulation

Historically, financial service provision in the UK was conducted within segmented markets. Thus chequing accounts were the preserve of the clearing banks whereas building societies enjoyed a near monopoly in the housing finance market. This segmentation was sustained by regulation which, in the case of the building societies, debarred them from entering new markets outwith their traditional areas of providing housing finance and financing this through savings deposits. There also existed very little internal competition since the societies themselves operated an interest rate cartel which, it was generally agreed, set a rate which permitted the survival of the least efficient societies.[7]

Several developments over the past decade have, however, significantly changed the building societies' operating environment. Firstly, in 1981, banks were permitted to enter the housing finance market, and they soon gained a significant market share by their less risk averse behaviour.[8] As a result, building societies lobbied to be allowed to enter the lucrative markets which had hitherto been restricted to banks. As was expected, given the pro-competitive stance of the government of this time, building societies were permitted limited diversification through the provisions of the 1986 Building Societies Act: to product areas such as unsecured lending, estate agencies, insurance, credit cards and cheque book facilities. The Act therefore allowed the societies to compete directly with banks.

However the *degree* of diversification permitted within the sector was still low, and building societies still remain highly regulated. Firstly, societies were required to hold 90% of their assets in the form of class 1 assets.[9] Secondly, only the larger societies—those with assets of £100 million—were permitted to enter the full range of new markets. Finally, increased competition was also engendered *within* the sector when the interest rate cartel was abandoned in 1983. Thus societies now operate in a far more competitive environment, and it may be conjectured that this increase in external control severely limits managerial behaviour. If

[6] Contrast, for example, Verbrugge and Goldstein's (1981) contention that S&Ls exhibit a preference for excess labour with Blair and Placone's (1988) findings than they do not. Mester (1989) has recently argued that most tests of mutual-stock differences are flawed in their assumption of a common technology. She proposes a more general test and finds no evidence of expense preferences.

[7] Historically, efficiency was measured in terms of management expense ratios.

[8] Banks advanced greater multiples of incomes and lent funds to borrowers unable to obtain building society finance.

[9] Class 1 assets are those loans raised on residential mortgages on primary residence properties.

this is the case there is no reason to suppose that agency problems are particularly severe in financial mutuals. Our discussion therefore turns to the issue of appropriate performance goals in building societies.

As noted at the outset, the remit of CEOs in mutual organisations is straightforward: they must manage the enterprise in the best interests of the owners.[10] In this sense their goals appear to be little different from the standard goal of the maximisation of shareholder wealth in a public company. Where these two forms of ownership differ significantly is that the owners of a mutual are also customers and that there may be disparate interests amongst the customer group.

Somewhat curiously, however, the notion of profit maximisation, indeed even of profit itself, has been eschewed within the sector. Thus societies traditionally refer only to a surplus in the accounts. Furthermore, much of the empirical work which was conducted on building societies claimed that inter-society profitability comparisons were inappropriate for mutual organisations. Frequently it has been said that mutual—and other so called 'not for profit'—organisations are more likely to exhibit managerial utility functions which do not include profit as an argument.[11] Thus the managerial models of Baumol (1967), Marris (1964) and Williamson (1964) have been considered to be more accurate reflections of managerial objectives. For the UK building societies it was normally hypothesised that the major objective for managers was the maximisation of the real growth of assets (Drake, 1989).

Kay (1991) notes, however, that for all organisations, mutuals included, the appropriate performance goal is the creation of added value. As he notes, where behaviour in a mutual may differ from that in a public company lies in how this added value is distributed amongst the interested parties. Thus differences may be observed in the share which managers capture via discretionary expenditures. Likewise Drake (1989) also recognises the increased importance of profit for building society managers.

Furthermore there are a number of other reasons why the generation of profit is an important performance indicator for societies. Firstly, unlike public companies, building societies have extremely limited access to external capital. Although the larger societies have limited powers to issue subordinated debt, their main capital for expansion and diversification must come from internal funds, i.e. from past profits. This point has become particularly important in the new regulatory environment since the new business opportunities opened up to the societies require greater capitalisation.

Secondly, the intensity of competition has increased both from within the sector and outside it. Thus the least profitable societies face possible extinction since they no longer enjoy the protection of the cartel. Furthermore, as the divide between the banking sector and the building societies lessens, comparisons of the relative profitability of the two types of institutions will be made both by customers—existing and potential—and by market analysts.

The 1986 Act allows societies to demutualise. Although the Abbey National is the only one to have adopted this strategy so far, surveys consistently indicate that other large societies keep the option under review. This encourages market analysts to make profitability comparisons as a guide for future investors. It must be expected, therefore, that the managerial labour market in the sector will also have regard for profitability, thus constraining managers' discretion to pursue other goals (Fama, 1980).

Finally, the ideal of societies as non-profit institutions may have been sustainable when their only product involved the financing of domestic house purchase—something widely considered as socially desirable—but is a good deal less sustainable for their newer activities. There appears no obvious reason why, say, the services of an estate agency or a commercial property financier should be provided *except* at a profit to the provider.

On the basis of the arguments presented above it is concluded that, in the current competitive climate, it is realistic to assume that building society managers may be considered to be as concerned as managers of other financial firms to aim to maximise profit. However, their competitive environment has not always been so demanding. Prior to deregulation in 1987 there was a strict demarcation between the societies and commercial banks. It is conjectured, therefore, that the regulatory changes will have increased the importance of profitability to managers. It was noted earlier that there is a major incentive for managers to pursue profits if there is a direct link between their pay and this measure of performance. In the following section we empirically investigate this relationship.

A model of executive compensation

Despite the plethora of empirical studies on executive compensation, there have been few studies on 'non-profits'. In the US, an early study of S&Ls by Herman (1969) and, more latterly Mayers and Smith's (1992) examination of the US

[10] Ownership rights are not universally enjoyed by all. For example chequing accounts frequently do not carry voting rights. Similarly borrowers are often denied such rights by societies.

[11] Drake (1989) provides a full discussion of the likely arguments of managerial utility functions in the building society context.

insurance industry highlighted the differential in compensation of stock companies' CEOs *vis-à-vis* their mutual counterparts.[12] Since all UK building societies are mutuals such an approach is not possible for the UK but, by considering variation in remuneration determination over time, we can assess the impact of deregulation.

If, as we suggest above, changes in the competitive conditions faced by building societies will have forced them into cost-minimising behaviour, then the standard, neo-classical model states that CEOs will receive a wage equal to their marginal product. Evidence, however, suggests that this rule is at variance with practice (Frank, 1984). Instead, managers are frequently remunerated according to factors such as organisation performance, their education, past experience and their position in the hierarchy. The most frequently cited reasons for this concern the problems associated with measuring individuals' productivity. The notion of joint production processes and the subsequent difficulty of monitoring individual effort has been noted by, *inter alia*, Alchian and Demsetz (1972), Harris and Raviv (1978) and Lazear and Rosen (1981). Although the arguments apply to all groups of workers, they can be deemed to be especially severe in the case of top management. Since the work of Penrose (1959) the importance of team as opposed to individual managerial effort has been recognised. Furthermore, even if it is possible to monitor managerial effort, it is not costless and it is likely that the marginal effect would be outweighed by its cost.

If, therefore, individual output measures are not obtainable, other information must be used to make inferences about individual performance. Clearly one set of alternatives is to use *firm* level output based measures such as profitability, sales or growth. As Hogan and McPheters (1980) note, such measures provide low cost indicators of performance. Arguably there exists greater justification for the use of such measures for CEOs than for other groups of workers since ultimately it is the CEO who is responsible for the overall performance of the organisation.

As an alternative to these output based measures, there are also a number of input based measures which can be used as indicators of worth.[13] One obvious indicator of an individual's productivity is their human capital (Becker, 1964). The contention of human capital theorists is that it directly enhances productivity. However, it can alternatively be viewed as a screening (or signalling) device (Spence, 1973). This view suggests that, although human capital *per se* does not directly enhance productivity, it screens for those individuals who are likely to become most productive once in post.

Notwithstanding the difficulties surrounding the choice of a reliable performance indicator, we have thus far assumed that with competitive markets we would expect to observe equality between marginal product and wage at any point in time. Although single period models have received much attention in the literature (Holmström, 1979 and Mirlees, 1976, for example) it is more realistic to consider the relationship between an individual's lifetime earnings and productive performance.

Human capital theory stresses that, during training, employees receive a wage less than their marginal product; clearly the expectation is that this will be recouped later in life via remuneration in excess of marginal product.[14] Furthermore, Lazear and Rosen (1981) contend that the reason that CEO pay is not a direct reflection of productivity is that it is a 'prize'. Thus, in their tournament model, all top executives compete for the job and the high salary attached to it. All top executives effectively fund the 'pool' by subsidising the CEO's salary; their willingness to do this derives from the fact that they may themselves be the winner.[15] Furthermore, it is likely that firms may well be forced to pay a premium to their CEOs to retain them. For example, efficiency wage models (Stiglitz, 1987, for example) contend that wages in excess of marginal product encourage honesty in employees and therefore minimise acts such as shirking.

The foregoing discussion therefore suggests that the determination of executive compensation is a complex process. As such, simple empirical models which link remuneration only to measures of organisation performance are likely to suffer from severe misspecification problems.[16] Our empirical model, therefore, includes both society specific and individual specific variables. We therefore posit:

$$COMP_{it} = f(X_{it} Z_{it}) \qquad (1)$$

where X and Z are vectors of society specific and

[12]There also exists a study of the US local public sector by Santerre (1991).

[13]See, *inter alia*, Finkelstein and Hambrick (1988). Indeed Murphy (1985, 1986) advocates the inclusion of these factors in all compensation equations on the grounds that their exclusion causes a severe omitted variables problem.

[14]The theory does, of course, state that firm specific training will be entirely financed by the firm. However since the majority of training is neither wholly general nor wholly firm specific, it is reasonable to assume that part of its cost is borne by the employee.

[15]Main (1991) notes that the tournament model would explain the very large salary increases that sometimes accompany an individual's promotion to the CEO post. He also, however, cites Murphy (1985) who disputes that such large increases occur frequently.

[16]The early compensation studies of McGuire, Chiu and Elbing (1962), Lewellen and Huntsman (1970), Masson (1971) and Cos (1975) adopted such parsimonious econometric specifications. For criticisms of these studies see Murphy (1985) and Ciscel and Carroll (1980).

individual specific variables respectively. Our variable definitions are as follows. Firstly, COMP is the salary received by the highest paid director.[17] Our data only allows us to identify salary; thus other forms of remuneration are excluded. However, given that mutuality precludes the use of stock options, our omissions are probably not substantial.[18]

The components of the X vector are, firstly, SIZE which, it is hypothesised, will positively affect performance. Thus, for the sector under consideration, SIZE reflects complexity of a society's operations given that current regulation restricts potential diversification opportunities via asset size classification. In addition, Mayers and Smith (1992) argue that CEOs are paid for exercising discretion. The ability to do this is much greater for the CEO of one of the largest societies than it is for the CEO of a small one. Both these arguments reinforce our prior expectation of the influence of this variable.

The remaining organisation specific measures which we include in our specification are traditional measures of performance. ROA, the return on assets, is a standard measure of profitability and, if this is found to influence remuneration positively, it would lend support to the neo-classical model. However it is unrealistic to assume that current profitability will affect current performance, thus a one period lag is imposed on this variable. Furthermore it may be more realistic to consider the effect of *relative* profitability on performance. In particular CEOs may well receive additional remuneration if they achieve year on year performance increases. To investigate this, PGRW, the percentage change in profitability, is included in our model; it is expected that PGRW will affect remuneration positively. As discussed above, the real growth in assets has historically been considered to be an appropriate performance measure for building societies; thus AGRW appears in our exogenous variable set. Positive significance of this variable would lend credence to 'managerialist' behaviour within the sector.

Turning to the individual specific characteristics, we employ a number of measures which proxy human capital endowments. The most basic manifestation of past human capital investments is the possession of certification which reflects individuals' educational attainments. Herein we employ two measures of such qualifications. First, the binary variable, Q1, takes the unitary value if an individual CEO possesses a degree. This variable reflects the amount of *general* human capital. To supplement this, the binary variable, Q2, takes the value one if an individual CEO possess a society sector qualification.[19] Whilst both Q1 and Q2 should positively affect remuneration we anticipate that the returns to general human capital will be greater given the transferability of such investments.

A further indicator of society specific human capital is the accumulated experience that a CEO has in post. To encapsulate this we include the variable EXP, which is measured by the number of years in post of a CEO. However, whilst as a reflection of human capital we would expect EXP to be positive, our expectation here is that CEOs with little experience will receive higher compensation. Thus, at the time of deregulation, few CEOs in the sector possessed experience of managing a diversified enterprise. Several societies recruited experienced managers from outwith the sector which necessitated that their remuneration was set at a sufficiently high level to attract them.

Furthermore general human capital is also amassed by all individuals over time. One reflection of this is the commonly observed positive slope of individuals' age earnings profiles. We therefore include AGE in our exogenous variable set. It is, however, generally agreed that the age-remuneration relationship is non-linear; to model this, AGE^2 is also included in our empirical specification.

Two further variables appear in our model. Firstly we include NODIR which attempts to proxy the Lazear and Rosen (1981) tournament effect. What is ideally required for this is a measure of the differential in compensation that the CEO enjoys over others who in the last 'tournament' competed for the position. Data limitations force us to proxy for this by using the number of directors in the highest paid category. Thus where NODIR is high—one for example—the differential between the CEO and the next highest paid director is high.[20] This, therefore, indicates that the 'prize' is similarly high. Empirically we anticipate a negative relationship between NODIR and COMP.

Finally we include INT, a binary variable with a value of one indicating that the CEO was a

[17]We are, therefore, making the assumption that the highest paid director is the CEO which, for UK building societies, is universally true. A parallel assumption is normally made in the case of PLCs (see, for example, Main, 1991).

[18]One obvious perk that CEOs in building societies will receive is a subsidised mortgage but we have no access to such information.

[19]Examples of such qualifications are an Associateship of the Building Societies Institute or a chartered surveying qualification. Whilst still providing the individual with general human capital we assume that the potential mobility of individuals with Q2 type qualifications is lower than that of individuals with Q1 type.

[20]NODIR is, unfortunately, a poor proxy with which to investigate the tournament effect. As noted by one referee, the pool of directors whose salaries are directly below that of the CEO frequently includes at least one person (usually older) who will not be a contender in the next round.

Table 1
Definitions and Mean Values of Variables

		1987	1989
Continuous Variables:			
COMP	Salary of highest paid director	£36,907	£53,958
SIZE	Total assets	£13,957 million	£17,586 million
ROA	Return on assets	19.7%	19.0%
AGRW	Real growth in assets	10.8%	30.7%
PGRW	Profitability growth	11.0%	−3.2%
NODIR	Number of directors in highest paid category	2	2
AGE	Age	49	48
EXP	Experience in CEO post	7	6
Binary Variables (0/1):			
Q1	Degree/no degree	0.27	0.29
Q2	Professional qualification/no professional qualification	0.87	0.92
INT	Internal appointment/external appointment	0.62	0.62

Notes:
1. All financial variables are expressed in 1985 prices.
2. Data sources: financial data and NODIR from Tekron database, data on personal characteristics from *Who's Who in Building Societies*.

member of the board of directors immediately prior to promotion to the top post. Thus, if a building society has to attract an external candidate to the CEO post they may well need to pay a premium; our expectation is that INT will negatively affect compensation. A full description of each of these variables, together with their mean values, is presented in Table 1.

To summarise, our full model is:

$$Ln(COMP)_{it} = \alpha + \beta_0 * SIZE_{it} + \beta_1 * ROA_{i_{t-1}} + \beta_2 * AGRW_{it} + \beta_3 * PGRW_{it} + \beta_4 * NODIR_{it} + \gamma_0 * AGE_{it} + \gamma_1 * AGE_{it}^2 + \gamma_2 * EXP_{it} + \gamma_3 * Q1_{it} + \gamma_4 * Q2_{it} * \gamma_5 * INT_{it} + \upsilon_{it} \quad (2)$$

where the usual semi-logarithmic specification is employed.[21]

Our financial data plus NODIR is taken from the Tekron database and relates to the population of societies in 1987. In order to be included in our sample, societies must have remained in independent existence until at least the end of 1989, and this leads to a degree of selection bias. The data are supplemented by information on the individual characteristics of CEOs taken from *Who's Who in Building Societies*.[22] To investigate the impact of regulatory change on remuneration determination we use two periods: (i) 1987, the year the Building Societies Act took effect;[23] and (ii) 1989, by when we expect that societies had had time to adjust to their new environment.

The results of our two cross-sectional regressions are presented in Table 2. Turning first to 1987, the results conform broadly to our *a priori* expectations. Furthermore the fit of our empirical specification is reasonable for cross-sectional analysis: our model explains almost half of the variation in remuneration. This suggests a high degree of regularity in CEO remuneration determination across the sector. Of the organisation specific variables, size is found to affect performance positively and NODIR is negative and significant, providing weak empirical support for Lazear and Rosen's (1981) tournament model. However both our measures of profitability—absolute and time relative—are negative and significant, thereby implying that CEOs with poor—and declining—profitability are, *ceteris paribus*, receiving higher remuneration than their counterparts in more profitable societies. This finding does not provide any support for the efficiency of the mutual form of the organisation.

Considering the individual specific variables we

[21] We here eschew the common practice of estimating (2) in first difference form as this would preclude examination of the time invariant individual effects.

[22] The availability of this information, together with attrition due to takeovers, reduced our final sample to 52.

[23] The use of this year for our first cross-section estimation is constrained by the regulatory change itself. Thus new reporting requirements were part of the 1986 Act. Although data on this new basis is available for 1986 this year was reserved for the creation of lagged values and growth rates.

Table 2
Cross Section CEO Compensation Estimates

Independent Variables	*1987*	*1989*
Constant	736.06	94.078
	(0.44)	(1.68)
SIZE	0.7261 E-04**	0.8337 E-04**
	(4.14)	(3.69)
ROA_{-1}	−0.0737**	0.0636
	(3.06)	(1.48)
AGRW	7.3905	0.9428*
	(0.44)	(1.72)
PGRW	−0.0189**	0.0089**
	(3.96)	(2.22)
NODIR	−0.1358*	−0.0463
	(1.94)	(0.64)
AGE	0.2776**	0.1434
	(2.04)	(0.97)
AGE^2	−0.0029**	−0.0014
	(2.03)	(0.95)
EXP	−0.0377**	−0.0096
	(2.15)	(0.56)
Q1	0.4188**	−0.1299
	(2.16)	(0.60)
Q2	−0.1232	0.3942*
	(0.71)	(1.86)
INT	0.1039	0.3022
	(0.58)	(1.19)
$\bar{R}^2$	0.4680	0.1490
N	52	52

Notes:
1. Heteroskedastic consistent covariance matrix used in estimation.
2. 't'—statistics in parentheses.
3. *indicates a variable is significant at 99% level.
   **indicates a variable is significant at 95% level.

find that AGE is positive, non-linear and significant as we hypothesised. Also in line with our expectation, EXP is negative reflecting the premium paid to CEOs recently entering their posts. This finding is clearly at variance with the human capital argument discussed above which would, of course, suggest a positive sign for this coefficient. Of our educational variables, Q1, which indicates general human capital, is both positive and significant. Our results do not however indicate any positive returns to sector specific human capital, since Q2 fails to achieve statistical significance. Finally, we found no evidence to suggest that CEOs previously on the board of directors received different remuneration to those who were not.

Overall the evidence for 1987 suggests fairly rigid remuneration determination within the sector. Although size was found to be an important determination of remuneration, individual specific factors were also important.

Moving to 1989, our results indicate some significant changes in the determination of remuneration. Firstly the statistical fit of the model is much reduced; our exogenous variable set explains under 15% of the variation in remuneration. Furthermore the F-test of the joint significance of the slope coefficients failed to reject the null hypothesis. Although the positive size-remuneration relationship is robust across the two periods, this robustness does not extend to our other findings. Of particular interest is the existence of a positive profitability-remuneration relationship for the latter period. Thus although ROA_{-1} does not achieve statistical significance in 1989, our time relative profitability measure (PGRW) is both positive and significant. Thus under the current regulatory regime our data does provide evidence for performance related remuneration.

Furthermore our 1989 data provide no support for the hypothesis that individual specific factors are important determinants of CEO remuneration. For 1989, therefore, our results indicate that remuneration is determined by only two factors: size and percentage changes in profitability. The first of these two findings is consistent with the contention of Mayers and Smith (1992) that CEOs receive higher salaries the greater the discretion that they are required to exercise. Clearly within the current

regulatory framework the amount of discretion involved in the management of one of the largest building societies exceeds that for one of the smallest. The significance of profitability changes indicates that, if performance improvements are a reliable indicator of increases in CEO productivity, top management in building societies are being rewarded for increases in effort.

To investigate further the apparent instability of our model we extended our analysis explicitly to consider how certain of the coefficients evolved over time. For this purpose we employed a panel data set for the years 1987–89.[24] As for most models with coefficients evolving over time we assume that there is no individual heterogeneity. Thus at any given t, the coefficient vectors, β_t, are the same for all societies.[25] The general form of time-varying models is:

$$Y_t = \beta_t X_t + u_t \qquad (3)$$

and

$$\beta_t = H\beta_{t-1} + \eta_t,\ t = 1, \ldots, T \qquad (4)$$

where X_t and u_t retain their standard definitions but η_t is an independent normal random variable, with zero mean and covariance matrix ψ; u and η are independent. Only when $H = I$, and $\psi = 0$ does the model collapse to normal regression. If $H = I$ and $\psi \neq 0$ the model reduces to the random walk model.

Our panel model was estimated across 144 observations (48 × 3) using a maximum likelihood approach and the results are presented in Table 3. These partition the coefficient vector into time-varying and time-constant sub-vectors. Our model thus became:

$$Y_t = \beta_t' x_t + \tilde{\beta}' x_t + u_t \qquad (5)$$

where the tilde indicates those parameter estimates assumed to be time-constant.

Turning first to the society specific variables, our results investigate the evolution over time of the impact of ROA, AGRW and SIZE.[26] As can be seen from Table 3, overall the model performs acceptably well with the likelihood ratio test rejecting the joint insignificance of our explanatory variable set. A further likelihood ratio test also rejected acceptance of the hypothesis that $\beta_t = \beta\ \forall\ t$. In considering the individual coefficients, it is clear that, with the exception of INT, individual-specific characters play no part in the determination of remuneration. Furthermore our relative profit measure—PGRW—also fails to achieve statistical significance.

From our time-varying parameter estimates it is immediately apparent that size remains an important determinant of remuneration over the period under investigation. However the interesting find-

Table 3
Panel CEO Compensation Estimates

Dependent Variable Ln (COMP)
Independent Variables

Constant	3.0689**
	(9.08)
$SIZE_{t1}$	0.9750 E-04**
	(5.00)
$SIZE_{t2}$	0.9889 E-04**
	(5.84)
$SIZE_{t3}$	0.8986 E-04**
	(5.76)
$ROA_{-1,t1}$	0.0629
	(1.26)
$ROA_{-1,t2}$	0.0204
	(0.44)
$ROA_{-1,t3}$	0.0897**
	(2.37)
$AGRW_{t1}$	−0.4211
	(1.00)
$AGRW_{t2}$	6.6210**
	(3.20)
$AGRW_{t3}$	12.7460**
	(3.67)
PGRW	0.0005
	(0.84)
NODIR	0.0215
	(1.61)
AGE	0.0064
	(0.23)
AGE^2	−0.0002
	(0.25)
EXP	0.0052
	(0.77)
$Q1_{t1}$	0.0036
	(0.03)
$Q1_{t2}$	0.1390
	(1.32)
$Q1_{t3}$	0.1382
	(1.23)
Q_2	−0.188
	(0.16)
INT	0.1919*
	(1.86)
N	144
Buse Raw-Moment R^2	0.9185
Log Likelihood	−9.09
Restricted Log Likelihood	−33.63

Notes:
**As for Table 2
*As for Table 2
$_{t1}$ = 1987
$_{t2}$ = 1988
$_{t3}$ = 1989

[24]For the panel data we lost observations on four societies due to missing data.
[25]See Hsiao (1986).
[26]We did in the course of our investigation allow other variables to have time-varying parameters. Details of these results are available from the authors.

ing of these results is the changing impact of both profitability and growth on remuneration over the period. Whilst the former of these two variables fails to achieve significance in the first two periods, for the end period it becomes positive and significant. Similarly, asset growth becomes a significant, positive determinant of remuneration after the base period. These results are not, of themselves, entirely conclusive. However, taken together with the earlier cross-section estimates they suggest that society performance became a much more important determinant of remuneration after deregulation.

Summary and conclusions

In this paper we have investigated the determinants of CEO remuneration in UK building societies. To analyse the impact of regulatory change within the sector we have employed cross-sectional analysis in two periods since the robustness, or otherwise, of parameter estimates serves as an indicator of the effect of regulatory change.

Our results clearly demonstrate that severe parameter instability does exist in our model of CEO remuneration. This is consistent with deregulation significantly affecting remuneration determination. To model this explicitly we employed an empirical specification wherein the parameter estimates were allowed to be time-varying. Our results showed that, whereas size remained important throughout the period, both growth and profitability played increasingly important roles in remuneration determination after deregulation. Given that both profitability and growth are viewed as primary objectives within the building society sector, our results suggest that the pay-performance linkage has strengthened in the more competitive environment.

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Markets, Hierarchies and the Regulation of the National Health Service

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Abstract—This paper draws on the markets and hierarchies perspective as originally espoused by Williamson and developed by Ouchi in examining the governance of the National Health Service. It traces an inversion of the processes of governance in the private sector (from markets to hierarchies to culture) to the NHS situation (from clan control to hierarchies to markets). The paper then examines the mechanisms of the new quasi-market in health care with particular reference to GP fundholders and the newly created self-governing hospital trusts. It explores its implications for key actors in the reformed NHS, and concludes that these market reforms will have far-reaching implications for managers, clinicians and, potentially, for the ownership of NHS facilities.

Introduction

This paper explores the merits of alternative modes of governance of the National Health Service (NHS), but focuses particularly on the market reforms introduced in 1989 (DOH, 1989). The theoretical perspective taken is that of 'markets and hierarchies', as originally espoused by Williamson (1975, 1978, 1991) and Chandler (1977) and developed by Ouchi (1977, 1979, 1980). As discussed further below, this form of analysis considers three competing modes of governance: (a) clan control (or culture-based control systems), (b) hierarchical (or bureaucratic, rules-based controls) and (c) markets. This perspective informs a critique of the NHS reforms. The paper covers two main topics: (i) markets, hierarchies and modes of governance—a discussion of competing modes of governance, with particular reference to the applicability of this theoretical framework to the public sector in general, and health care in particular; and (ii) the NHS reforms—the introduction of the internal market in health care.

This analysis is necessarily somewhat speculative, given the infancy of the NHS reforms. Nevertheless, it is suggested here that the implementation of these reforms may entail considerable transaction costs. This paper also explores whether there will be significant changes, not only in the behaviour of managers and the medical profession, but also in organisational forms. It specifically addresses the issue of whether the internal market will lead to the possibility of privatised, successful trusts on the one hand and managed/hierarchical controls for providers of public hospital services on the other.

Markets, hierarchies and modes of governance

The markets, hierarchies (M&H) perspective derives from the classic work of Coase (1937), in which he suggested that organisations supplanted markets for many products and services to minimise transaction costs, i.e. it is more efficient to function as one large organisation than as numerous smaller organisations. That such a shift (from markets to hierarchies or bureaucracies) has taken place has been documented by Chandler (1977) and Chandler and Daems (1979). This shift has aroused considerable interest in issues arising from the changing boundaries between organisations and the market and, consequently, theories of behaviour within organisations (see Stiglitz, 1991). One such theory is the M&H perspective as developed and espoused by Williamson (1975, 1978, 1991). This rests on two behavioural assumptions: (a) bounded rationality (the recognition of the cognitive limits of rational individuals) and (b) opportunism (the existence of the moral hazard of the pursuit of self-interest to the extent that sanctions/monitoring are necessary). The impact of these assumptions is outlined in Table 1.

The implications of these assumptions for contract setting are exacerbated, according to Williamson's theory, where (a) there are frequent transactions, (b) there is considerable uncertainty, and (c) asset specificity exists. Both (a) and (b) may be regarded as self-evident. However, (c) adds the additional dimension that, where there is a transaction which entails significant investment in durable, highly specific assets, the parties to the transaction are bilaterally dependent (Williamson,

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Table 1
Organisational implications of M&H behavioural assumptions

	Behavioural Assumptions	
Implications	*Bounded Rationality*	*Opportunism*
For contractual theory	Comprehensive contracting is infeasible	Contract as promise is naive
For economic organisation	Exchange will be facilitated by modes that support adoptive, sequential decision making	Trading requires the support of spontaneous or crafted safeguards

Source: Williamson (1991).

Note: The dashed vertical line denotes that the contractual implications and organisational responses are joint responses to a combined condition of bounded rationality and opportunism.

1991, p. 94) which further complicates the contract setting process. A major response to such difficulties can be seen as the development of large organisations, in which rules-based behaviour (penalties, incentives, bureaucratic rules regarding approval and decision making) constrain the likelihood of these imperfections in the contract setting process in markets—which is in itself a response to the problems of incomplete contracts.

The M&H perspective has not gone without criticism. One such attack is that it is only preoccupied with economic efficiency and does not adequately address issues of power and control within organisations (Perrow, 1981). It has also been suggested (Simon, 1991) that the M&H perspective is itself incomplete because there are further dimensions of intra-organisational behaviour (for example authority, co-ordination, identification) which must be brought into play to understand processes within organisations. However, there have been attempts by M&H proponents to extend and develop the theory to take account of such criticisms, notably the contributions by Ouchi (1977, 1979, 1980), Ouchi and Price (1978) and Williamson and Ouchi (1981), in which the concept of corporate or 'clan' culture is offered as an important dimension in understanding modes of governance.

The concept of corporate culture has generated a wide literature in recent years which seeks to explain governance within organisations. The specific form of culture identified by M&H proponents is that of 'the clan' in which there is 'soft contracting' between parties within organisations based on incomplete contracts and a more elaborate informal governance apparatus (Williamson & Ouchi, 1981). The 'clan control' system relies on social controls rather than on the legal or economic sanctions of the bureaucratic organisation.[1] The emergence of such a regime is seen as being dependent upon the 'institutional infrastructure within which soft contracts are embedded' (p. 361). In his analysis of the clan mechanism as a means of governing the organisation, Ouchi cites the distinctive nature of the behaviour of health care professionals in developing this concept (Ouchi, 1977, p. 837):

> Consider . . . the general hospital. In the case of many health care employees, even the most dedicated attempts at systematic performance auditing would be frustrated. Task performance is inherently ambiguous, and teamwork is common, so that precise evaluation of individual contributions is all but impossible. In such cases we observe a highly formalised and lengthy period of socialisation during which would-be doctors and nurses are subjected not only to skill training but also to value training or indoctrination . . . they are certified with respect not only to their technical skills but also with respect to their integrity or purity of values . . . when [this socialisation process] refers to the properties of a unique organisation, we may refer to it as a clan.

This analysis of the organisation of hospitals is supported by other observers of health care delivery, including Harrison and Schultz (1989) and Perrow's (1961) classic study of the medical profession in hospitals. However, Ouchi has extended this analysis in the context of the 'markets, hierarchies', framework, as shown in Table 2. This extension is based on four dimensions of the three modes of governance (markets, bureaucracies or clan): (a) social and (b) informational requirements for their effective functioning, (c) knowledge of the transformation process, and (d) an ability to measure outputs.

[1]The concept of the 'clan' is still being developed by M&H proponents. For example, Alvesson and Lindkvist (1993) depict the 'clan' as taking one of three forms—(a) the economic-cooperative clan; (b) the social-integrative clan; and (c) the blood-kinship clan.

Table 2
Markets, hierarchies and clan control compared

1.

Type of control	Social requirements	Informational requirements
Market	Norm of reciprocity	Prices
Bureaucracy	Norm of reciprocity Legitimate authority	Rules
Clan	Norm of reciprocity Legitimate authority Shared values, beliefs	Traditions

2. *Control type and antecedent conditions*

		Knowledge of the Transformation Process	
		Perfect	Imperfect
Ability to measure output	High	Behaviour/Output measurement	Output measurement
	Low	Behaviour measurement	Ritual and ceremony 'Clan' control

Source: Compiled from Ouchi (1979).

On the matter of social and informational requirements, the fundamental social requirement of market based governance is the norm of *reciprocity*, i.e. parties to market transactions behave honestly and, if not, the offending party is punished not just by the person cheated but by the social system as a whole. In this situation, prices are sufficient information for the market to function effectively. The alternative to this is that honesty cannot be assumed, and parties to contracts must take responsibility for the costs of surveillance, complete contracting and enforcement to eliminate cheating (see Williamson, 1991), with the likelihood of excessive transaction costs and market failure. Where there is such market failure, the bureaucratic mode of governance may be employed in which both the norm of reciprocity and rules-based behaviour are necessary. In this situation, employees of organisations accept the legitimacy of their superiors to direct and monitor their activities, in exchange for wages.[2] The distinguishing feature of the system of clan control is the absence of explicit signals or criteria comparable to the prices of the market and the rules of bureaucracy. Instead, there is a reliance on shared values and beliefs—common agreement on appropriate behaviour and high commitment to this code of behaviour. Observing these traditions is essential to the functioning of the clan based system of control.

As noted above, this latter form of governance has been described as particularly apposite in the case of health care. This is accentuated by the antecedent conditions which govern different control relationships (see Table 2, part 2), i.e. knowledge of means-end relationships and an ability to measure outputs. In both markets and bureaucracies, there is an implicit assumption that the means of service delivery or of converting raw materials to finished products is well understood and that performance can be measured. However, where knowledge of the transformation process is imperfect and the ability to measure outputs is low, Ouchi suggests that the precise contribution made by individuals cannot be assessed and more subtle forms of control, which rely on trust and the shared values of the clan, may be exercised. This circumstance is seen as particularly applying to public sector organisations by Ouchi (1977).[3] These issues are explored further, in the rest of this paper, in the specific context of the reforms of the NHS.

The M&H perspective has identified a shift from markets to bureaucracies and to an increasing interest in the concept of culture, in general, but the clan, in particular, as modes of governance. As Figure 1 shows, this represents an inversion of the modes of governance in the NHS. The nature of these changes, the reasons for them and the likely impact of the prescribed market solution for the NHS are now considered.

[2] This is not seen as a strict mechanical relationship on the part of the employees. Ouchi (1979), for example (p. 838), writes of a 'zone of indifference' in which employees will not respond to financial inducements.

[3] This analysis, and its applicability to public sector organisations, is also supported by Hofstede's (1981) analysis in which he characterises situations in which (a) the effects of managerial intervention are not known, (b) output is not measurable, and (c) objectives are ambiguous as requiring a form of political control. He ascribes the application of bureaucratic modes of control (routine, repetitive) in such situations as the reason for their failure.

From clans to markets

The NHS has been characterised as an organisation which has been dominated by the medical profession (Bourn and Ezzamel, 1986; Burke and Goddard, 1990). In their analysis, Bourn and Ezzamel describe the medical profession as a clan. Drawing on Ouchi's (1980) extension of Williamson's (1975) work, they argue that the NHS is typified by high goal congruence on the part of the medical profession and by high performance ambiguity (which is tolerated by clan members) and that this has given rise to 'the clan'. In their view this 'clan' behaviour is also supported by important symbols and practices, such as clinical freedom. However, the medical profession can be seen as one distinct sub-culture within a complex organisation. Bourn and Ezzamel recognise this (p. 214), by locating the 'medical clan' within bureaucratic elements (i.e. by the use of the term 'enucleated bureaucracy'). However, they argue that the medical clan *dominated* within such administrative or financial constraints.

This is consistent with Lapsley's (1992) suggestion that for most of its life, in the absence of well developed management information systems, NHS finance officers have operated financial management by stealth, often using crude control techniques (accelerating or slowing down payments, building up or running down stocks, delaying the replacement of vacancies) to balance the books. However, this regime led to accusations of considerable internal transaction costs. Specifically, it was characterised as a model of governance which led to unnecessarily lengthy delays in decision making, to behaviour which was geared to problem avoidance rather than solution, and to 'institutionalised stagnation' (Griffiths, 1983).

Such criticisms gave rise to the reform of the NHS hierarchy by the implementation of an explicit, managerial model (general management) which also emphasised the importance of new accounting controls. The prediction of Bourn and Ezzamel (1986) was that this would prove to be no more than a ritual, and, indeed, there is evidence to support this view. For example, Harrison *et al.'s* (1989) findings of a large study of key actors in the NHS arena (including general managers, consultants, authority members, nurses) based on unstructured interviews, documentary evidence and non-participant observation, suggest that general managers will rarely challenge doctors except when forced to do so by financial exigencies (p. 44). Similarly, a study of 68 general managers by Williams and Dopson (1988) found that most of these had an NHS background and they were not intent on dramatic managerial change.

Furthermore, similar criticism can be made of the attempts to support this new style management in the NHS by the introduction of management budgets, in which the medical clan would have financial responsibilities within the formal hierarchy of the NHS. This has been a story of failure, for which Perrin (1988, pp. 108–111) documents the reasons, including inadequate resources, an over-ambitious time scale and a limited appreciation of the complexities and nuances of introducing such a substantive change in the face of strong professional independence (i.e. in our terms, the medical clan). The most recent initiative—the resource management initiative (1986)—was

Figure 1
Dominant modes of governance: an inversion of private sector and NHS experiences

Private sector	*National Health Service*
MARKETS	CLAN-BASED/CULTURE CONTROL
↓	↓
HIERARCHIES	HIERARCHIES
↓	↓
CORPORATE CULTURES	MARKETS

Notes: 1. It is important to note that these alternative modes of governance are described as *dominant*, i.e. Markets, Hierarchies proponents would recognise that hybrid forms of governance may exist and that there may be a mixture of modes of governance at any point in time.
2. It is not suggested that these shifts occurred *in parallel*. The switch from markets to hierarchies in the private sector has been documented by, for example, Chandler (1977) as occurring to a large degree at the end of the last century and early this century, whereas the NHS was not established until 1947. The important issue here is the *inversion* per se, not the time frame.

designed to improve management budgeting, principally by broadening the base of information generated. In the Department of Health's formal evaluation of resource management, Packwood *et al.* (1991, p. 157) concluded that, based on a study of the designated (and hence well resourced and supported) trial sites, progress was 'slow and patchy' and that these sites had 'some way to go' before a complete resource management system was in place. At the time of the publication of the Packwood report, plans were already well advanced for even more dramatic reforms of the governance of the NHS, by the introduction of the internal market (discussed below). But it would appear that, as predicted by Bourn and Ezzamel, the control exerted by the medical clan (as constrained within the enucleated bureaucracy) retained an important role in the governance of the NHS, throughout the attempt to implement an explicit, rules-based, managerial hierarchy in the 1980s.

Regulating the NHS: a market solution?

While the new style hierarchical controls do not yet appear to have weakened the influence of health care professionals, the advent of a market solution to the regulation of the NHS may do so. The White Paper (DOH, 1989) has introduced the concept of a market in health care, but it is important to recognise that a 'market solution' to the governance of the NHS may be, and to some extent has been, implemented in a variety of ways. This section of this paper addresses the differing forms which the market solution has taken so far and might take in the future and considers specifically whether privatisation is likely to emerge as the ultimate market solution to the problems of the governance of the NHS. These issues are explored below by considering (i) the possible application of established theories of privatisation to the NHS and (ii) the rationale for, and evidence to date on, the efficacy of the market solution prescribed for the NHS, and whether this may lead to a private market in health care.

Theories of Privatisation

The two dominant theories of privatisation which have supported the UK government are those of (a) the *property rights school* and (b) *contestable market theorists.* As regards (a), the adoption of a pure property rights approach is based upon a rejection of the concept of state ownership because it denies 'the rights of individuals to the use of resources' (Alchian, 1965, p. 817). If this method of privatisation were to be implemented there would be a conversion of the publicly owned NHS into a private corporation. In a debate on the NHS in the House of Commons, the then Secretary of State for Health, William Waldegrave, refuted the assertion by the Leader of the Opposition that 'the Tories will privatise the Health Service' and reaffirmed the Prime Minister's statement that there would be no charges for hospital treatment, no charges for visits to the doctor, no privatisation of health care, neither in part nor as a whole, now or in the future; and welcomed the Prime Minister's 'unequivocal assurance' that Trust hospitals would remain a permanent part of the NHS (*Hansard,* The National Health Service, p. 660, 21 October 1991). It is hard to imagine a more definite rejection of NHS privatisation. Given recent debates over the future of the NHS and the delicacy with which outright privatisation is regarded by all political parties, consumers and other interested commentators, this seems most unlikely for the foreseeable future.

An alternative approach to privatisation is the gradualist one which draws on the theory of contestable markets (see Bailey, 1981; Baumol *et al.*, 1982; Bailey and Baumol, 1984), in which markets for public services are opened up to *potential* entrants. This threat (of new entrants into the market) is seen as the single most effective means of ensuring maximum efficiency in service provision by contestable market theorists. This is the thinking behind the introduction of compulsory competitive tendering (CCT) for a whole variety of NHS services, which started with ancillary services, is being extended to clinical laboratories and may be extended to other areas of the NHS such as financial and management services. To the extent that the potential entrants become actual providers of services previously provided by the NHS, there is a process of privatisation. There is evidence that this process has generated substantial savings for the tendering of domestic services but has encouraged 'loss-leaders', and there has been evidence of contractor failure (Domberger *et al.*, 1987). It has been shown (Milne, 1987) that in-house retention of such contracts remains the best means of ensuring quality control and eliminating the kind of opportunistic behaviour identified by Domberger *et al.* However, the importance of CCT has been overshadowed by the creation of the internal market in health care, which may also lead to a more gradualist approach to the privatisation of NHS services.

The Prescribed Market Solution for the NHS

Enthoven (1985) is attributed with the thinking behind the prescribed market solution for the NHS, i.e. the creation of an internal or quasi-market in health care (as described in the government's White Paper, DOH, 1989). This sub-section examines (a) the key concepts which comprise the internal market, particularly the *purchaser/provider* split, and the potential impact of such reforms on hierarchical and clan modes of

controlling NHS activities and (b) then considers the efficacy of this market from the perspective of GP fund-holders (as *purchasers*) and self-governing trusts (as *providers*), both of which are novel organisational forms introduced as part of the NHS reforms and which are pivotal elements of the internal market.

(a) Concepts Underpinning the Internal Market

The introduction of the *internal* or *quasi-markets* in the NHS represents the most dramatic and significant change in the organisation of this public service since its inception. The significant differences stem from the redefinition of the roles of health authorities as *purchasers* and hospital units as *providers* of health care. Under the new regime of the internal market, the health authorities become *purchasers* of hospital services, with budgets based on their resident population and its characteristics, on behalf of consumers in their area. They are not the sole purchasers, as fund-holding GPs may also buy services, but at the moment the size of the overall GP budget expenditure is relatively small at c.1% of overall expenditure for hospital and community health services (Robinson, 1992). The *providers* of hospital services, which include directly managed (NHS) hospital units, self-governing hospital trusts and independent hospitals compete with each other for contracts with purchasers (health authorities/ GP fund-holders).

The aim of this internal market is to increase the efficiency of health care provision and, thereby, to increase the overall level of patient care (without concomitant additional resources). However, this market solution to providing efficient health care has been criticised as being inappropriate, on the grounds that, in terms of the M&H model, the transaction costs of operating such a system are high. Specifically, there are high transaction costs associated with the specification of contracts because (1) there is considerable uncertainty, not only over cause and effect of particular treatments, but also because of the unpredictable nature of much non-elective medical care, (2) the sheer scale of the number of contracts which would require to be placed on a 'cost per case' contracting system places limits on decision makers, both purchasers and providers (bounded rationality) and (3) there is scope for opportunistic behaviour (e.g. providing high prestige services at higher cost to the detriment of overall quality of service), within this system (Burke and Goddard, 1990; Bartlett, 1991). Also, there are major difficulties for providers in generating sufficiently precise costing information to enable such contracts to be made. This circumstance has promoted the use of block contracts, in which a block of services is purchased in exchange for a fixed sum, but these, too, may be subject to opportunistic behaviour, particularly because of incomplete information (see Bartlett, 1991).

In terms of competing modes of governance, there is the prospect that the introduction of the quasi-market with its purchaser/provider roles will weaken the powerful position attributed to the medical clan. Before internal markets, the medical profession exerted considerable influence not only over the level and pattern of admissions, but also over the consumption of resources within hospitals. Now that decisions on levels of activity lie within the hands of purchasers and providers, money will follow patients, and this may come to represent an attenuation of the traditional position of the hospital consultants. This may prove to be inappropriate, in Ouchi's (1980) terms, on account of the perceived high goal congruence within the medical profession and the ambiguity over what constitutes a good performance in health care (see Bourn and Ezzamel, 1986, and Burke and Goddard, 1990). Furthermore, the implementation of a market mechanism with high transaction costs may fail and require some form of hierarchical or rules-based intervention to reduce/minimise such costs, and there is some evidence of this with a move to managed competition.[4]

(b) The Purchaser/Provider Split

The above criticisms of the market model adopted for the NHS are supported by a closer examination of available evidence on the GP fund-holder as a purchaser, and the new self-governing trusts as providers. This reveals favourable conditions for opportunistic behaviour; major uncertainties (particularly in the contracting process); bounded rationality and, to some extent, the negative impact of small numbers on the functioning of the market. These typify the high transaction costs identified where the market solution is inappropriate. It is also suggested below—and this is necessarily tentative—that the above instances of market behaviour may lead to the possible privatisation of some self-governing hospital trusts. These two aspects of the purchaser/provider split are considered in the remaining sections.

The GP fund-holder as purchaser

At a time when the scope of fund-holding by general practitioners is being extended to include

[4]It is worth noting that the unrestricted use of market mechanisms has already been softened, with transitional arrangements for the London hospitals which would otherwise have faced rapid rationalisation and possible closures because of the high cost of their activities, relative to other hospitals, following the Tomlinson report on the London hospital services. See *Public Finance and Accountancy*, 19 February, 1993, p. 3.

items such as district nursing,[5] there are controversies surrounding the efficiency of their present purchasing role. On the one hand, it has been suggested (Glennerster *et al.*, 1992, p. 31), that this practice may lead to a number of possible 'efficiency scenarios':

1. fewer routine follow-up appointments,
2. better (i.e. quicker) pathology service,
3. closed wards reopened,
4. hospital consultants in GP surgeries,
5. use of the budget to offer less elaborate but appropriate care at a lower price, e.g. increased physiotherapy and less drug treatment.

However, items 1, 3 and 5 could be achieved without fund-holding, and items 2 and 4 need not be efficiency gains, and may lead to less visible inefficiencies elsewhere. Indeed, other evidence suggests that, to date, (a) there are significant possibilities for opportunistic behaviour, (b) the basis upon which the budgets are constructed for fund-holders are dubious and incomplete, and (c) the contracting process has given rise to considerable uncertainties. In terms of the M&H analysis, this market solution could be shown to be inappropriate. However, this system is still in its infancy and these reservations can be treated with some degree of caution.

As regards (a), one major anticipated example of opportunistic behaviour on the part of GP fund-holders is that of *adverse selection* (Scheffler, 1989). This occurs where GP practices admit patients on the basis of their health, rejecting the chronically sick and encouraging healthy patients on to their lists. Other instances of such opportunistic behaviour by fund-holders might include the arrangement of treatment such that this becomes a cost to the provider, rather than the GP fund-holder, as purchaser, by delaying referrals of patients until they become emergencies and by making inappropriate referrals (i.e. medicine rather than surgery). Monitoring for this kind of behaviour could become a major transactions cost of operating the new market. Glennerster (1992) in his study of ten GP fund-holders did not find evidence of this, but his investigation was not exhaustive.

This kind of perverse incentive might extend to new organisational forms as the dynamics of the market place develop. One specific outcome might be the establishment of limited companies by GP practices to which GP fund-holders may, in turn, refer their patients. This, in effect, removes the purchaser/provider split and the quality of care offered by such facilities may be inferior to that provided by larger, better resourced hospitals. Again, this type of activity by GP fund-holders will be monitored by Health Authorities and Family Health Service Authorities at some unknown cost.

There are also examples of GP fund-holders establishing a two-tier level of service. Thus Glennerster (1992) found that fund-holders, by taking their patients to other providers, or by threatening to do so, gained improvements in the quality of service purchased (e.g. shorter waiting times, same day service from pathology services). Also, Glennerster (1992), Bain (1992) and Glynn *et al.* (1992) found evidence of hospital consultants conducting clinics in GP surgeries which represents an improvement in service to fund-holders' patients, but may be at a cost of range and quality of care in the hospital unit. Other examples of this two-tier effect arose where clinics and theatre sessions, which had been cancelled because of funding difficulties, were resumed at the behest of fund-holders and at which consultants saw fund-holders' patients who were of lower clinical priority (Roland, 1992).

Another major constraint on the effectiveness of GP fund-holders which has affected the contract-setting process and resulted in incomplete information and bounded rationality is that of the construction of GP budgets. The purchase budget for hospital services is based upon historical referral patterns by GP practices. However, it has been shown that much referral pattern data is inadequate (see Bain, 1991; Glennerster, 1992). For example, Glennerster found health authorities using referral data for as little as three months in constructing fund-holders' budgets. However, referral rates might vary considerably at different times of the year. An evident effect of this method of allocation is that practices with high cost and high referral rates will be awarded large funds, unrelated to efficiency, and vice versa. Indeed, Day and Klein (1992), in a study based on 80% of all first wave GP fund-holders (251 practices), found considerable variation in budgets allocated by regional health authorities. They estimated that 'taking the country as a whole, the highest spending fund-holders received twice as much to spend on each patient for hospital services than (*sic*) their more parsimonious colleagues' (p. 169). This broad difference masks considerable variation. For example, when Day and Klein's data is presented as a total budget allocation per patient, the variation within one region ranges from £52 to £176.

These issues are exacerbated by the operation of the market itself. The original concept of a market dominated by patient choice has become one which is mediated by GP fund-holders and which is based

[5]This extension of fund-holding also includes health visiting, chiropody, dietetics, community and out-patient mental health services, mental health counselling, health services for people with learning disabilities, referrals by health visitors, community mental handicap nurses (see *NHS Management Executive News*, No. 60—August, 1992).

on differing approaches to contract setting, which in turn appears to be a function of limited information. Thus, a critical element in contract setting is what constitutes 'quality' to permit purchasers to make cost/quality trade-offs in managing their budget. This concept has proved to be slippery in practice, with pragmatic definitions which hinge on attributes such as speed of response rather than clinical care. It is not surprising, therefore, that GP fund-holders have exhibited different attitudes to quality of care, with some accepting these more superficial aspects of care provision, and others seeking to set their own terms (see Glennerster, 1992). These are examples of incomplete information, where contracts are set on cost and waiting list length (which *are* important), but not on outcome and quality of patient care at competing provider units, which are just unknown. These uncertainties in contract setting have been reported as the most difficult stage of GP fund-holding (Bain, 1991; Glennerster, 1992). This evidence, preliminary as it is, appears to vindicate the critique of the market solution to the governance of the NHS, in so far as it affects one key group of purchasers. The situation regarding a growing provider group, self-governing hospital trusts, is discussed next.

Self-governing hospital trusts as providers

The internal market is in place, and there has been a third wave of bids by provider units to become self-governing hospital trusts, with the likelihood that this will become the dominant mode of provision over the next few years. As yet, there is limited information on the behaviour of such trusts and the efficacy of the supply side of the market. However, informed comment raises questions about its ultimate effectiveness. One particular issue is the ability of the provider units to compete. This can be limited because of the specialised nature of some facilities (e.g. heart surgery). There is also the circumstance of spatial monopoly in which there may be only one provider unit with a local monopoly (see Appelby *et al.*, 1990). In terms of the M&H analysis, these are instances of asset specificity, in which there is a bilateral (or quasi-bilateral) exchange relationship and extremely complex forms of contracting and in which internal organisation (bureaucracies) offers a more efficient means of organising the production and delivery of services.

Another major consequence of the implementation of the internal market will be the emergence of 'winners' and 'losers' within provider units. The winners will attract additional patients and, thereby, resources, because they are able to offer healthcare which has been costed at a lower level. They may also be more favourably placed to attract additional resources from a variety of sources, such as commercial financiers, sponsorship and charitable donations. Large modern hospitals with economies of scale stand to gain. On the other hand, hospitals which are relatively more costly may lose patients (and resources) and become even more costly as activity diminishes. Other NHS hospitals with a lack of modern facilities may fail to gain the most attractive patients (in terms of resource contribution or financial payoff) (see Mohan, 1990).

These uncertainties are underlined by the nature of contract setting and the possibilities for opportunistic behaviour created at self-governing hospital trusts. It is interesting to note that one of the leading trusts (in terms of costing developments, at least), the Freeman hospital, has expressed concern at its ability to generate accurate internal costing information for contract setting (see Laurence, 1991a and 1991b). Not only do these trusts face such uncertainties in contract setting, but the environment in which they operate is also conducive to opportunistic strategies. The fundamental attribute of self-governing hospital trusts which makes this status so attractive to hospital units is that of *devolved management*. The specific form of devolved management in these trusts is attractive because it is combined with a particular financial package. Specifically, the management of such trusts can:

—determine local pay, employment conditions and employment structure (staff mix),
—keep surpluses,
—borrow funds,
—have public dividend capital.

The first of these may be seen as an attempt to break national pay bargaining and the influence of organised labour, in the expectation that locally determined pay and conditions of employment will deteriorate. Indeed, in areas of high unemployment, this flexibility may be used by trusts to reduce pay and conditions. However, this need not be the case. Instances of improved pay and conditions might be expected in areas where there is scarcity of specific types of health care staff, although this may lead to competition for such staff between trusts in close proximity (it may also be that directly managed hospital units lose out in this process).

While the ability to vary conditions of employment may have captured more attention, the financial structure of the new trusts is of even more interest, particularly from the perspective of possible privatisation. In the first instance, trusts are allowed to make and keep surpluses, which may encourage opportunistic strategies. This is a radical departure from previous circumstances where any health authority surplus (which would take the form of an underspending) would be surrendered to the Treasury. Indeed, trusts are

given specific profitability targets—usually 6% return on capital employed.

Closer examination of the method of accounting for capital shows that profits may be even greater, in private sector terms. While the new method of capital accounting introduced to the NHS as part of these reforms is described as being comparable to the private sector, it is not (see DOH, 1989; Lapsley, 1990). Basically, private sector companies compute the depreciation charge as a deduction from income on the basis of the historical cost of assets held. In the NHS, the depreciation charge is based on the current replacement cost of assets held (plus a notional charge as a proxy for the financing of assets held). If the profits of a trust were converted to the private sector basis, an apparently more attractive profitable opportunity might be available.

This circumstance should be considered in relation to the financial structure of these trusts. This is comparable to private sector practices, with both borrowings and equity capital. Trusts have public dividend capital (PDC) which is the public sector proxy for the ordinary share capital of the private sector. This financial instrument used to be confined to those nationalised industries which were viable, profitable and operating in competitive markets (see Lapsley, 1985). However, as trusts remain a part of the NHS, their level of borrowing is constrained by the Treasury (which sets external financing limits for each trust), as their overall borrowing forms part of the Public Sector Borrowing Requirement. This kind of restriction, and the fact that trusts will still receive other guidance from central government may make the attractiveness of 'devolved management' seem illusory. These circumstances could be exacerbated by the introduction of the profit motive (even as constrained, at present) and the devising of opportunistic strategies by NHS managers. Indeed, it may make the management of successful trusts wish to leave the public sector. The most likely mechanism by which this might be achieved would be by management buy-out.[6] If this happens, it is unlikely to be uniform, with the 'losers' and directly managed hospital units remaining within the public sector, perhaps in a more hierarchical form of control framework. All of this is necessarily speculative, but can be seen as a possible consequence of (in terms of M&H) the introduction of market-based controls in circumstances which promote significant transaction costs by permitting uncertainties in contract setting, and creating bounded rationality and opportunistic behaviour.

This emphasis on the internal market, the generation of prices for services offered, the creation of financial targets and the monitoring of financial performance may have fundamental effects not only on the management (and possibly ownership) of these trusts, but also on the medical clan. It is possible that the role of hospital doctors may strengthen as internal resource allocation within these trusts becomes more transparent and less reliant on obscure, protracted dialogue and negotiation between doctors and management. However, in terms of Ouchi's framework (see Table 2), the arrival of the profit and loss account for specific trust hospitals and the acceptance of financial criteria provides measures of output by which the performance of trust hospitals can now be assessed. Also, the identification of the financial contribution made by specific medical specialities (which will emerge as provider units move from block contracts to cost and volume and cost per case contracts) transcends the enucleated bureaucracy, as the performance of medical specialties will be assessed in terms of their contribution to the trusts' profit or loss. This shift removes one of the key antecedent conditions for clan control and its reliance on ritual and ceremony. The knowledge of the transformation process may remain imperfect, because of the variations possible in medical practice and the continuing innovation in such practices. But the pressures of the market place may lead to further weakening of the clan with management challenging clinical practices which exhibit apparent cost inefficiencies (see for example, Harrison *et al.*, 1989).

Conclusion

This paper has examined modes of governance of the NHS from a 'market, hierarchies' perspective. This theoretical framework, which rests on an analysis of contract setting processes, has been applied primarily to studies of private sector organisations, in which the move from markets to hierarchies/bureaucracies and to clan/culture based systems of governance has been observed. However, it has been shown above that this framework has a particular relevance to the NHS, and that the adoption of the current mode of NHS governance—the internal market—represents an inversion of the private sector experience.

In the NHS, the domination of its activities by the medical clan has been challenged by reforming the bureaucracy (principally by the implementation of general management and new accounting controls). Available evidence suggests that such changes did not weaken the influence and power of the medical clan in the 1980s. However, the

[6]In an analysis of the privatisation programme, Wright, Thompson and Robbie (1993) show that the management buy-out is the most frequently used device for transferring smaller public sector organisations (such as, in this case, self-governing hospital trusts) to the private sector. This policy often hinges on the buy-out organisation's management identifying incentives for efficiency gains and dissatisfaction with the penalty/reward structure of public ownership.

internal market, with its creation of health authorities and GP fund-holders as purchasers and directly managed hospital units, self-governing hospital trusts and private hospitals as providers, represents a change of a different order. The M&H perspective suggests that this market will be characterised by high transaction costs. There are favourable conditions for opportunistic behaviour: major uncertainties in the contract setting process, bounded rationality and, to some extent, the likelihood of the negative impact of small numbers on the functioning of the market. This may lead, ultimately, to greater monitoring, surveillance and management of competition. The impact of introducing financial performance evaluation criteria for self-governing hospital trusts on the medical clan may also be profound. This weakens one of Ouchi's key antecedents for the existence of the clan, i.e. the existence of ambiguity over performance assessment. Also, the available strategies for self-governing hospital trusts, the future dominant mode of hospital provision, are such that successful, profitable trusts may seek private sector status. These issues are of interest to policy makers, practising accountants and accounting researchers and should be addressed by further research as the story of the implementation of the NHS internal market unfolds.

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The Audit Expectations Gap in Britain: An Empirical Investigation

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Abstract—This paper reports the results of a postal questionnaire survey to ascertain the perceptions of individuals about audit expectations issues in Britain, including: what the role of the auditor is and should be; what prohibitions and regulations should be placed on audit firms; and what decisions auditors could be expected to make in a series of mini-cases. The questionnaire also included a semantic differential testing instrument which, through factor analysis, provides evidence about what different groups of individuals perceive to be the key attributes of auditing activity. The survey included chartered accountants in public practice, corporate finance directors, investment analysts, bank lending officers and financial journalists.

The audit expectations gap has a long and persistent history. While recent financial scandals such as Johnson Matthey Bankers, Barlow Clowes, Ferranti, Polly Peck and BCCI, and the frequent parliamentary questions about the auditing profession, have raised the profile of the expectations debate, the central issues incorporated within it (such as fraud detection, auditor independence, public interest reporting and the meaning of audit reports) have not only remained unresolved since the emergence of the term 'audit expectations gap' in the 1970s, but also have a history that is as long as that of company auditing itself (Humphrey *et al.*, 1992).

The literature relevant to the expectations problem in auditing is extensive, ranging, for example, from empirical and experimental research to ascertain beliefs about auditing and its effects on the decisions of particular groups to analysis of legal judgements and to the work of various professional and governmental investigations established to consider audit related issues. Without documenting all of this literature in detail (see Gwilliam, 1987 and Humphrey, 1991 for general discussions), the debate on expectations issues can be seen to cover, broadly, the specification of the role or functions that auditing is intended to fulfil, communications and reports from auditors, the structure and regulation of the provision of audit services, and the level of quality in the performance of audits. Evidence of uncertainty surrounding audit roles has been provided by opinion surveys in a number of countries (see, for example, Beck, 1973; Arrington *et al.*, 1983; Porter, 1989) and by the continuing criticisms of auditors in relation to, for example, fraud, going concern and the general conduct of business activity (Mitchell *et al.*, 1991). Similarly, variation in interpretation of the meaning of different audit reports has been researched, both to demonstrate the existence of possible problems (e.g. Holt and Moizer, 1990) and to investigate possible solutions (e.g., Hatherly *et al.*, 1991). Structural and regulatory issues including auditor independence, procedures for appointment and the competitive position in the auditing services market have featured prominently in the reviews by a number of government and profession sponsored commissions (e.g. AICPA, 1978; Metcalfe, 1978; AICPA, 1987; CICA, 1988; Cadbury, 1992). Concern about the quality of auditors' performance is evidenced in litigation involving claims of substandard audit work (see Gwilliam, 1991), although the so called 'litigation explosion' also reflects other factors concerning the specification of roles and the economics of auditing activity.

Different underlying explanations have been offered for the continuing presence of significant expectations problems over a long period of time. For example, a common response of the auditing profession has been to stress the misguided nature of external expectations, arguing that the investing public expects too much and remains largely ignorant as to the precise nature, purpose and capacities of the audit function. This approach often leads to the suggestion that the solution to the expectations gap is to educate the public as to what auditors recognise as their duties and responsibilities (and limitations upon them) through, for example, publication of Auditing Standards and Guidelines,

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giving general assurances that the audit profession can be trusted to serve the public interest, and changing the wording used in audit reports. The expectations gap has also been represented as the result of a natural time lag in the auditing profession identifying and responding to continually evolving and expanding public expectations (e.g. Tricker, 1982).

In contrast, a growing number of writers have begun to argue that the expectations gap is perhaps a consequence of the contradictions in a self-regulated audit system operating with minimal government intervention (Hopwood, 1990; Humphrey *et al.*, 1991, 1992; Sikka *et al.*, 1992), and that the actions of the profession in relation to the gap must be seen in a more self-interested light. Evidence for this view is taken from the fact that a number of investigations have concluded that users of accounts generally hold reasonable expectations of auditors' abilities and the nature of audit assurances (e.g. CICA, 1988) and from the persistence with which certain topics have dominated the expectations agenda, casting doubt on the 'ignorance' and 'evolution' explanations.

In recent years, the high public prominence of expectations questions about auditing has been accompanied by an increasing resort to rhetoric, as a means of both attack and defence. Some in the auditing profession have seen the expectations gap as an insecure exercise in navel gazing and have criticised the financial press for its envious 'sniping' (*Accountancy*, September, 1990, p. 1) and for conjuring up a problem that does not exist. Concerns as to auditors' performance have on various occasions been dismissed for their weak empirical basis, or as an over-exaggerated response to the isolated failings of individual auditors. Others, both within the auditing profession and external to it, have taken the criticisms arising from expectations issues as reflecting serious matters of professional ethics.[1]

What has been lacking from the UK debate on audit expectations, and what has allowed the rhetoric to thrive, has been adequate empirical evidence against which alternative characterisations and explanations, such as those mentioned above, can be judged. In recent years some surveys of the public's view of auditing have been undertaken (e.g. Steen, 1990) but little direct evidence of comparative differences between the views of practising auditors and those of the recipients of audit services has been available. The purpose of this paper is to provide such evidence. The paper reports the results of a study of how auditors and their work are perceived by various groups interested in the financial reporting process: chartered accountants in public practice,[2] financial directors, investment analysts, bankers and financial journalists. The reported findings are derived from responses to a mail questionnaire survey undertaken towards the end of 1990 and examine whether an expectations gap can be associated with occupational group membership.

The next section of the paper outlines the development of the questionnaire. Subsequent sections describe the groups surveyed and analyse the questionnaire survey results. The paper concludes with some reflections on the significance of the analysis and its implications for the closing of the expectations gap.

Development of the questionnaire

The questionnaire included four main elements: (i) a series of questions designed to elicit opinions on the role and nature of auditing broadly similar to those used in opinion surveys in other environments; (ii) a further set of questions to identify what attributes respondents appear to associate most closely with the performance of auditors; (iii) a series of short case studies asking respondents what action they would anticipate that auditors would take in particular circumstances; and (iv) questions relating to a series of background biographical and personality variables. This paper presents the results from the first three types of question, analysed to identify the extent to which auditors differ significantly from other groups in their interpretations of matters relating to auditing and auditors.

As the basic concept of an expectations gap concerns differences in opinions, the use of a questionnaire opinion survey has some justification as a research approach, although the normal limitations of this method, concerning consistent interpretation etc., obviously apply. It is possible that responses could reflect different degrees of familiarity with auditing and that opinions could be expressed about roles, services and regulations without adequate consideration of associated costs. Attempts were made to minimise such difficulties through pretesting, the inclusion of a number of different questioning strategies and, as described below, the use of particular methods in the development of the questionnaire. Variation in familiarity with the audit function is not really a problem as the purpose of the study is to identify where different perceptions about auditing exist, not the validity or authority of particular perceptions. That is, the study is intended to assess

[1] In this respect, some practitioners (e.g. see Letters to *Accountancy*, December, 1990, p. 5; January, 1991, p. 5; July, 1991, p. 5) have publicly expressed concern about the perceived increasing business orientation of accounting firms and the possibility that it compromises the auditor's position.

[2] Chartered accountants in public practice were to be partitioned on receipt of completed questionnaires into 'auditors' and 'accountants'—see later.

whether differences in expectations can be associated with occupational groupings, not which expectations are 'correct'.

The Role and Nature of Auditing

The first part of the questionnaire covered the principal aspects of the audit process and the nature of auditor responsibilities, in a manner similar to previous studies in different countries, for example, Canada (CICA, 1988) and New Zealand (Porter, 1989). The questions in this section comprised a series of assertions regarding existing and possible audit roles, regulations and the audit environment, against which respondents were asked to indicate their agreement or disagreement on a seven point scale.

Aspects of Auditor Performance

The second part of the questionnaire consisted of a semantic differential testing instrument requiring assessment of the performance of auditors against various attributes. The purpose of this approach was to identify what performance factors are most closely associated with views about auditing, rather than just the demands for particular services etc. as examined in the first part. In order to ensure that the appropriate performance attributes were included, the development of this section of the questionnaire relied on repertory grid analysis of a large number of background interviews about auditor performance. For readers unfamiliar with the approach, it is probably helpful to outline the procedures followed (an introduction to the topic can be found in Smith, 1986a and 1986b).

The use of repertory grids developed from personal construct theory (Kelly, 1955), which set out the structures which Kelly believed were used to cope with the complexities of life. Kelly proposed that within day to day living each individual carries around a system, the purpose of which is to make sense of the environment. Individuals adopt for themselves yardsticks (constructs) based on experience, which can be applied to any new situation, enabling this new experience to be quickly labelled and catalogued. The personal construct system is a personally organised system of interpretation or construction of events. Kelly admitted that, whilst constructs were indeed individual and personal, different people may exhibit similar constructs, though they may not mean exactly the same thing to the individuals concerned (Hallsworth, 1988, p. 44).

In order to elicit an individual's personal constructs, it is first necessary to produce a set of elements which can be presented to a subject. As the aim of our exercise was to produce a repertory grid of the constructs used by individuals to view auditing, one element had to be auditing itself. It seemed logical therefore to use other job descriptions as the elements to present to individuals. After a series of brainstorming sessions and pilot testing, a list of 16 elements was produced: auditor, fraud squad officer, management consultant, weather forecaster, doctor, solicitor, umpire, property surveyor, insurance underwriter, foreign exchange dealer, government statistician, financial journalist, quality controller, tax inspector, sales representative and used car salesman. The choice of elements was governed by two criteria. First, the elements had to be within the range of convenience of the constructs to be used, i.e. subjects must be given the opportunity to say if a construct is inapplicable to an element. Second, the elements had to be representative of the pool from which they were drawn, since failure to include all (or as many as possible) of the relevant elements will weaken a study's conclusions.

In interviews, a dyad method was employed to elicit the constructs used by individuals to interpret the activity of auditing. Each subject was presented with auditor and another occupation, and asked to decide whether there was a similarity or a difference between the two elements and to verbalise this. The constructs were produced from these verbalisations. 71 subjects were interviewed in this manner (38 professional auditors, 26 investment analysts and 7 financial directors). The resultant repertory grids were used to produce a semantic differential to describe the activity of auditing based on aggregating the constructs of the 71 subjects.

In order to produce an average, or consensus, set of constructs, it was necessary to collate all the individual repertory grids. The first attempt produced 57 constructs, which were then reduced to 19 by using a thesaurus to avoid duplication. Semantic differential instruments are usually bi-polar adjectives (good–bad), but in this case it made more sense to use a Likert scale, to collect information on how successful respondents thought that auditors were at the activity constructs. To test whether the audit expectations gap was produced by the reaction of individuals to professionals more generally, the questionnaire included similar testing instruments for two other occupational groups, tax inspectors and solicitors.[3]

Case Studies

The concept of an expectations gap suggests that non-auditors would expect auditors to act in ways which are different from what auditors themselves would expect to do. To provide further evidence on this point, the questionnaire contained six mini case studies to elicit perceptions about auditors'

[3] A factor analysis of the repertory grids produced from the interview data revealed these two occupations to be the most closely associated with the perceived key functions of the auditor.

Table 1a
Response rates

	Mailed	Usable replies	Usable response rate %
Chartered accountants in public practice*	600	272	45.3
Financial directors	1000	372	37.2
Investment analysts	400	91	22.8
Bankers	220	161	73.2
Financial journalists	225	39	17.3
Total	2445	935	38.2

*Of the 272 returning usable replies in this group, 168 were classified as auditors and 104 as accountants (specialising in areas other than auditing—see Table 1b).

Table 1b
Work specialisations of 'accountants'

	Number	%
Taxation	47	45.2
Corporate finance	14	13.5
Insolvency	10	9.6
Technical	8	7.7
Management consultancy	7	6.7
Administration/Other	18	17.3
	104	100.0

reporting of information and the extent of audit work. The cases asked for a total of nine responses, two of which referred to possible audit report qualification issues, two to whistle-blowing issues, one to a possible resignation issue and four to issues relating to how much work an auditor would be expected to undertake.

Survey samples and response rates

Once constructed, the questionnaire was pilot tested and then distributed to five groups: chartered accountants in public practice, financial directors, investment analysts, bankers involved in corporate lending and financial journalists.[4] An attempt was made to include a sample of income tax inspectors in the study, but the Inland Revenue declined to participate in the project. Details of the distribution of the questionnaire and the responses obtained are given in Table 1a. The overall usable response rate was 38.2%

Within the biographical information, a significant number of the responding chartered accountants categorised their main area of work as being something other than auditing. Such activities included taxation, insolvency, management consultancy, corporate finance and technical work. The precise distribution is provided in Table 1b. In the analysis that follows, those chartered accountants who listed their main activity as a non-audit area are referred to collectively as 'accountants', giving a further occupational grouping for testing. The respective sample sizes that resulted from this partition were 168 'auditors' and 104 'accountants'.

Analysis of the questionnaire results

As indicated in the introduction, the purpose of this paper is to provide evidence about the important features of any identifiable 'gap' between the

[4]The sample of chartered accountants was a random selection from accountants in public practice in major British cities as listed in the membership handbook of the Institute of Chartered Accountants in England and Wales (ICAEW). Financial directors were drawn from the *Times 1000* list of major UK companies. Investment analysts were sampled from *Briton's Index of Investment Research Analysts in the UK* (Briton and Caulton, London). Questionnaires to bankers involved in corporate lending were distributed with the cooperation of four clearing banks. The sample of financial journalists was created by a manual search of leading newspapers and journals.

perceptions of different occupational groups as to the work of auditors and the nature of auditing. Accordingly, we will present only those results where differences between groups were apparent and merely note where no differences occurred. The Kruskal–Wallis one-way analysis of variance by ranks was used as the primary statistical test of significance. This test is regarded as particularly powerful for analysing non-parametric data such as that collected in this survey to decide whether a number of independent samples (in this case six samples) are from different populations (Siegel and Castellan, 1988, p. 206). As well as determining statistically significant differences, it was felt that we should provide some indication of the scale of the various differences. This is particularly important as so many of the survey questions produced significant differences across occupational groups at the 5% (and even the 1%) level of significance. To indicate the relative scale of the difference across groups we have reproduced in the tables the actual value of chi-square where significant differences were obtained.

Because of the low level of response from the financial journalists and the fact that, as can be seen in the tables, the pattern of their responses did exhibit more strongly stated opinions, checks were made to ensure that the overall results from statistical analysis comparing the groups surveyed were not biased by the journalist group. To eliminate this concern the Kruskal–Wallis test was re-run, with the financial journalists excluded from the analysis. The resulting chi-squared values generally differed only marginally from the ones with the journalists included, providing firm evidence that the journalists were not driving the expectations gaps being observed. The discussion and tables which follow therefore report the results for analysis across all groups, but the few individual instances where exclusion of the journalists either caused or removed a significant difference are noted in the relevant tables (see Tables 7, 8 and 12).

What is notable in the results of the survey is the regularity with which a significant amount of the variation in responses can be attributed to the one variable of occupational group membership. The very essence of the expectations gap rests on the assertion, which is supported by this evidence, that those relying on the audit function have views about it which are different to those held by auditors. In the tables of results which follow, all differences significant at the 5% level have been recorded, a significance level which meant that the chi-squared value had to be greater than 11.07 (given 5 degrees of freedom).

Audit Roles

Views about auditors and the auditing process

Respondents were asked to indicate their agreement or disagreement with each of thirteen statements regarding current auditing practice. All thirteen produced significant differences and these are shown in Table 2.

The largest difference related to the statement that too much was expected of auditors by the investing community (chi-squared = 233): 82% of accountants and 73% of auditors agreed with the statement, the financial directors were almost equally split on the issue (42% disagreeing, 19% neutral and 41% agreeing), but the three user groups disagreed (overall 67% of users disagreed). The second largest difference concerned the statement that audits generally take too long to complete: 79% of auditors and 59% of accountants disagreed with the statement, the financial directors were neutral overall, but 49% of users agreed with the statement. The feeling was strongest on the part of the bankers, 67% of whom agreed with the statement. Other particularly large differences concerned auditors' abilities to understand business problems and their role with respect to improving, and reporting on, management efficiency. Interestingly, whilst 82% and 86% of auditors respectively felt that auditors did understand business problems and should identify ways of improving management efficiency, only 46% of them felt that auditors should report to shareholders on the efficiency of management. User groups generally saw a greater need for such reporting, although they were less confident about auditors' capacities to understand business problems.

Views about the auditor's role with respect to company financial statements

Respondents were asked to indicate their agreement with four aspects of the auditor's role with respect to financial statements—to ensure that: (i) they comply with company law, (ii) they comply with accepted accounting practice, (iii) they contain no significant deliberate distortions, and (iv) they contain no significant accidental errors.

Significant differences across groups were obtained for the latter three aspects of the auditor's role concerning financial statements (see Table 3a), although the scale of divergence was much lower than in both the general questions on the audit process (see Table 2) and in questions on the role of the auditor in relation to the audited company (see Table 3b).

Views about the auditor's role with respect to the audited company

Six questions were asked on the subject of the auditor's role with respect to the audited company. All six produced significant differences as listed in Table 3b.

In all cases, auditors saw a more restricted role than did either the financial directors or the three user groups. The relationship between

Table 2
Views about auditors and the auditing process

	A	*AC*	*FD*	*IA*	*B*	*J*	*Chi²*
Quality of company audits has increased in recent years	4.9	4.7	4.1	3.7	4.1	3.2	105
Too much expected of A's by investing community	5.2	5.5	3.9	3.3	3.1	2.7	233
A's are too concerned with keeping company management happy	3.7	4.0	4.1	4.9	4.8	5.5	94
Auditing process seriously weakened by imprecise accounting standards	4.0	4.1	4.2	4.5	4.6	5.0	21
A's are too willing to settle negligence claims out of court	3.8	3.9	4.2	4.4	4.0	4.6	20
An audit is of very little benefit to a company	2.4	3.0	3.6	2.7	2.5	3.2	80
Audits generally take too long to complete	2.6	3.2	4.0	4.1	5.1	3.9	207
A's do not understand the problems of business	2.5	3.0	4.1	4.1	3.7	3.4	147
Audits provide significant protection against fraud	3.1	3.0	2.8	3.2	3.5	2.9	30
A's should be identifying ways to improve management efficiency	5.6	5.3	4.5	4.3	5.7	3.8	125
A's should report to shareholders on management efficiency	3.7	4.2	3.7	4.2	5.1	4.9	81
Audit committees of non-executive directors should improve A independence	5.3	5.3	5.1	5.4	4.7	5.6	40
The quality of audit work is adequately regulated by the audit profession	4.1	4.1	3.7	3.2	3.7	3.0	34

Above means based on the seven point scale: 1 = Strongly disagree, 4 = Neutral, and 7 = Strongly agree.
A = Auditor, AC = Accountant, FD = Financial director, IA = Investment analyst, B = Banker, J = Journalist.

auditors and accountants was less consistent, but in no case were the mean responses of either auditors or accountants higher than those of financial directors or users (i.e. more supportive that a particular activity should be part of the audit function). The scale of the differences points quite clearly to a major role expectations gap with respect to the auditor's responsibilities for fraud detection, efficiency assessment, public interest reporting and company valuation. The most striking difference and the second largest in the entire questionnaire concerned the statement that one of the auditors' roles should be to ensure that the balance sheet provides a fair valuation of the company: 73% of auditors (and 66% of accountants) disagreed with this statement, whilst 58% of financial directors and 81% of users agreed with it. Thus even though a considerable proportion of auditors and accountants (42% and 46% respectively—see Table 2) were of the opinion that imprecise accounting standards were seriously weakening the audit process, there would appear to be little support amongst them for a 'tightening up' of standards to address the gap between balance sheet values and company net worth.

A second important difference recorded in Table 3b relates to whether the auditor's role should be to ensure that all significant fraud is detected. This difference is not surprising since fraud is a subject which has lain at the heart of much of the expectations gap debate over the last hundred years (Humphrey *et al.*, 1991). Accountants were least supportive, with only 43% of them indicating that this should be seen as an audit responsibility; 60% of the auditor respondents agreed with the statement compared with 62% of financial directors and a notable 86% of users. Another important role expectations gap is evident regarding whether

Table 3a
Views about the auditors' role with respect to audited financial statements of companies

Should be to ensure that they:	*A*	*AC*	*FD*	*IA*	*B*	*J*	*Chi²*
Comply with company law	6.7	6.5	6.6	6.5	6.4	6.6	NS
Comply with accepted accounting practice	6.7	6.5	6.5	6.5	6.5	6.5	18
Contain no significant deliberate distortions	6.6	6.5	6.6	6.6	6.7	6.7	16
Contain no significant accidental errors	6.3	6.1	6.2	6.2	6.5	6.5	15

NS: Not significant

Table 3b
Views about the auditors' role with respect to the audited company

	Should be to ensure that:	*A*	*AC*	*FD*	*IA*	*B*	*J*	*Chi²*
1	All significant fraud is detected	4.4	3.8	4.7	5.6	6.2	5.9	161
2	A satisfactory system of internal control is being operated	5.5	5.7	6.0	6.0	6.3	5.9	30
3	The future viability of the company is not in doubt	4.8	4.6	5.1	5.2	5.8	5.6	47
4	The company is being run efficiently	3.3	3.4	3.9	4.2	5.2	4.5	123
5	The appropriate regulatory authorities have been informed of any significant malpractice	5.0	4.8	5.1	5.8	6.2	6.1	84
6	The balance sheet provides a fair valuation of the company	2.6	2.8	4.5	5.1	6.0	5.8	237

Above means based on the seven point scale: 1 = Strongly disagree, 4 = Neutral, and 7 = Strongly agree.
A = Auditor, AC = Accountant, FD = Financial director, IA = Investment analyst, B = Banker, J = Journalist.

the auditors' role with respect to the audited company should be to ensure that the company is being run efficiently. Only 23% of auditors and 32.7% of accountants agreed, compared to 42% of the directors and 62% of the users. When coupled with the responses in Table 2 regarding the auditor and corporate efficiency, the survey can be seen to show a clear preference amongst user groups for extending the auditor's role to include reporting on how efficiently the company is being run. Auditors rank equally with management in rejecting a reporting role which extended to giving details on management efficiency to shareholders (less than 50% of both groups were in favour).

Views about groups to whom auditors should be responsible

Table 4 details the opinions expressed concerning whether the auditors of a company with significantly misstated financial statements should be liable to certain groups if the audit report fails to disclose the true position.

There were significant differences (at the 5% level) for all four groups tested as to whom the auditor could be potentially liable. The largest differences respectively concerned the auditor's responsibility to potential creditors, potential shareholders and existing creditors, none of whom are recognised automatically in law in the UK following the Caparo decision by the House of Lords (Caparo Industries v. Dickman [1990] 1 All ER HL 568, 63–72) (Mills, 1990). Auditors and accountants on average disagreed with the suggestions of liability to potential shareholders and creditors, whilst financial directors and the user groups generally agreed with them. There was broad agreement with the proposition that auditors should be responsible to existing creditors,

Table 4
Views about the groups to whom auditors should be responsible
'If a company's audited financial statements are significantly misstated and the audit report fails to disclose the true position, to what extent do you agree that the company's auditors *should* have a legal responsibility to the following groups for any loss arising from their reliance on the audited financial statements?'

	A	*AC*	*FD*	*IA*	*B*	*J*	*Chi²*
Existing shareholders	6.3	5.9	6.3	6.5	6.1	6.4	21
Potential shareholders	3.3	3.2	5.0	4.8	5.5	5.1	161
Existing creditors	4.6	4.1	5.6	5.8	6.0	5.7	116
Potential creditors	3.0	2.9	4.6	4.6	5.6	4.9	188

Above means based on the seven point scale: 1 = Strongly disagree, 4 = Neutral, and 7 = Strongly agree.
A = Auditor, AC = Accountant, FD = Financial director, IA = Investment analyst, B = Banker, J = Journalist.

although again the strength of support was much greater amongst users (86%) and financial directors (82%) than amongst auditor and accountant respondents (62% and 53% respectively). The balance of support observed amongst the latter groups could reflect some concern within the accounting profession about the restrictive nature of the Caparo decision.[5]

Views about possible prohibitions and regulations on an audit firm

Seven propositions relating to the regulatory framework of auditing were included in the questionnaire together with a statement about the profit making motive. All eight statements produced significant differences as shown in Table 5.

The largest difference concerned another historically prominent component of the expectations gap debate, namely, the proposition that an audit firm should not provide management advisory services to its audit clients. Auditors and accountants tended to disagree strongly with this suggestion, whereas financial directors, investment analysts and bankers only weakly disagreed. In contrast, financial journalists tended to agree strongly. A similar pattern of answers was given in response to the proposition that an audit firm should have a maximum period of office. Auditors and, to a lesser extent, accountants tended to disagree strongly; financial directors, investment analysts and bankers disagreed weakly; but financial journalists agreed with the proposition. The idea of limiting auditor liability by statute was supported by the auditor and accountant respondents, but all the other groups disagreed.

[5]For instance, an editorial in *Accountancy Age* (29 September 1991, p. 12) concluded that, if anything, the restrictive nature of the Caparo case had increased the ammunition available to the accounting profession's growing band of critics.

In examining the patterns of responses, it is worth noting that auditors and accountants were generally more supportive than the other occupational groups of existing regulations concerning audit independence (such as the prohibition on audit firms from owning shares in their audit clients and not being able to earn more than 15% of total income from any one audit client). In contrast, they were less supportive than the other groups of possible additional prohibitions that have been frequently voiced in the financial press and government consultative documents (such as restricting the provision of management services and limiting the auditor's period of office). The notion that professionalism should override all other considerations was given little support by the responses of auditors and accountants to the profit motive question: 85% of auditors and 86% of accountants disagreed with the proposition that an audit firm should not act primarily to make a profit, although on average it was only the financial journalists who as a group agreed overall with the proposition.

Performance Attributes of Auditing

As described earlier, a semantic differential testing instrument based upon repertory grid analysis of interviews was used to test perceptions about the success of auditors as judged against 19 different attributes of performance. Looking at the elements of the testing instrument separately, the largest difference (and the largest difference in the whole questionnaire) concerned the activity of coping with risk and uncertainty (see Table 6): 86% of auditors thought that auditors were successful at coping with risk and uncertainty, compared to only 58% of accountants, 29% of financial directors and 20% of users. Other notably large differences related to the auditors' success at diagnosing problems, forming correct judgements, limiting their own responsibility, acting independently without

Table 5
Views about possible prohibitions and regulations on an audit firm

An audit firm should:	*A*	*AC*	*FD*	*IA*	*B*	*J*	*Chi²*
Prohibit its members from owning shares in its audit clients	6.8	6.6	6.1	5.8	5.6	6.5	94
Not provide management advisory services to its audit clients	1.5	1.9	3.1	3.6	3.0	5.0	215
Not act primarily to make a profit	1.9	1.8	3.3	3.2	2.9	4.1	145
Not be able to earn more than 15% of total income from any one audit client	6.2	5.8	5.4	5.6	4.6	5.6	105
Have a maximum period of office	1.8	2.5	3.6	3.5	3.2	5.0	171
Have its audit methods checked by a professional standards body	5.3	5.2	5.3	5.4	6.0	6.1	44
Have its appointment and fee determined by a body independent of the client	2.4	3.0	2.9	3.6	3.2	4.6	60
Have limited liability determined by statute	5.1	5.3	3.6	3.7	3.1	3.3	176

Above means based on seven point scale: 1 = Strongly disagree, 4 = Neutral, and 7 = Strongly agree.
A = Auditor, AC = Accountant, FD = Financial director, IA = Investment analyst, B = Banker, J = Journalist.

regard to self interest, being even handed with the interests of others and making a profit. The chi-squared figures associated with the responses to these questions ranged from 154 to 250. This approximately means that the percentage of variation in responses (on each audit activity) explained by the one variable of occupational group membership ranged from 15% to 25%—a quite clear indication of the strength of a performance (and not just role) based audit expectations gap.

One approach to the expectations gap is to regard it as something which is inevitable with specialised professional activity and common to all professions.[6] It was not possible within this study to confirm or deny the existence of particular expectations problems affecting other professions. eIt was, however, possible to test whether the expectations gap identified in this research as affecting auditors is rooted in respondents' attitudes to professions in general or reflects distinct views about auditing practitioners. To do so, respondents were asked to evaluate the success of tax inspectors and solicitors against the same 19 performance attributes used for auditors. These two occupational groups had been identified from the findings of the earlier structured interviews as being most closely associated with the functions perceived as being performed by the auditor. In particular, tax inspectors were seen as serving similar compliance based duties, whilst solicitors matched the auditor's advisory activities. The evaluations for these professions were compared to those for auditors. The null hypothesis for this test for a general professional bias was that there should be no difference between the evaluations of auditors' success and those for tax inspectors and solicitors. The results for tax inspectors and solicitors are shown in Tables 7 and 8 respectively.

The first point to note is the number of insignificant differences across occupational groups—particularly for tax inspectors, where 9 of the 19 activities failed to provide significant differences. There were more significant differences for the responses on the success of solicitors (17 out of 19), but the size of the differences for both solicitors and tax inspectors are of a quite different magnitude to those observed in relation to auditors (see Table 6). The chi-squared values are all under 60, suggesting that the variable of occupational group membership generally is a far less influential factor on the responses concerning the performance of tax inspectors and solicitors with respect to

[6] An example of such an argument was evident in a leader column in *Accountancy Age* (15 August 1991, p. 10) when commenting on criticisms of the profession by Labour MP Austin Mitchell and others: 'Their main charge against the accountancy bodies, labelled as trade associations, is that they are neither open nor democratic and do not represent the wider social interest. This is undoubtedly true—but the same charge can be levelled against any professional body'.

Table 6
Views about how successful auditors are at particular activities

	A	*AC*	*FD*	*IA*	*B*	*J*	*Chi²*
Diagnosing problems	5.5	5.2	4.1	4.1	4.0	3.8	195
Prescribing remedies to problems	5.1	4.8	3.9	3.9	3.7	3.6	147
Acquiring information	6.0	5.7	5.0	5.0	4.7	4.7	139
Coping with risk and uncertainty	5.5	4.8	3.9	3.3	3.5	3.5	250
Predicting the future	3.7	3.3	3.0	2.4	3.1	2.8	61
Publicising their services	4.3	4.4	4.9	4.4	4.2	4.6	39
Making a profit	5.0	5.0	6.1	5.8	5.8	5.7	154
Detecting errors and irregularities	5.2	4.9	4.4	4.4	4.5	3.6	71
Preventing errors and irregularities	4.3	4.2	3.6	3.6	3.7	3.0	40
Complying with professional rules	6.0	6.0	5.8	5.6	5.6	4.9	33
Enforcing legal requirements	5.5	5.4	5.5	5.1	4.9	4.7	38
Forming correct judgements	5.7	5.5	4.8	4.1	4.5	3.9	187
Acting independently without regard to self-interest	5.7	5.5	4.5	4.0	4.4	2.9	180
Communicating effectively	4.6	4.5	4.7	3.9	3.8	3.5	79
Reporting truthfully	5.9	5.9	5.4	5.0	5.0	4.2	106
Being even-handed with the interests of others	5.6	5.6	5.0	4.2	4.3	3.4	175
Limiting their own legal responsibility	3.5	3.4	5.3	5.3	5.2	5.1	184
Providing a useful service to clients	5.6	5.3	4.6	4.7	4.7	4.6	91
Providing a useful service to society	5.2	4.9	4.1	4.0	4.1	3.4	90

Above means based on the seven point scale: 1 = Extremely unsuccessful, 4 = Neither successful nor unsuccessful, and 7 = Extremely successful.
A = Auditor, AC = Accountant, FD = Financial director, IA = Investment analyst, B = Banker, J = Journalist.

the attributes tested than it was for auditors' performance.

However, on its own, such a comparison of the responses to the survey questions is a rather limited test of professional bias. This is because it does not control for an upward scaling of the size of the differences across groups caused by auditors rating their own performance in Table 6, and with there being no corresponding self-rating by tax inspectors or solicitors in Tables 7 and 8. To eliminate any such scaling effect, it was necessary to compare the views of each occupational group as to the comparative success of (1) auditors and tax inspectors and (2) auditors and solicitors. Such comparisons were tested using the Wilcoxon signed ranks test (Siegel and Castellan, 1988, p. 87) and all significant differences (at the 5% level) are reported in Tables 9 and 10.

The results confirm the existence of a significant self-rating bias for auditors, who consistently rated their own performance as significantly better than that of tax inspectors and solicitors.[7] The only exceptions concern the activity of making a profit (where solicitors are deemed more successful), limiting their own legal responsibility (both tax inspectors and solicitors rated better) and enforcing legal requirements (solicitors rated better). The responses of the accountant group, who like auditors were all chartered accountants, follow a very similar pattern.

[7]It should be noted that our semantic differential testing instrument is not a device to be used to provide a comprehensive scoring of the relative effectiveness of a variety of professions/occupations. The constructs included in the instrument are audit related constructs. As such, it may well exclude relevant aspects of the work of tax inspectors or solicitors. Similarly, some of the activities of auditing may not be relevant to the work of tax inspectors or solicitors. To accommodate the latter, the questionnaire included a 'not applicable' column. The former was not of concern, as the purpose of including tax inspectors and solicitors in the questions was not to judge their overall performance, but to examine how views on auditors' performance compared with those of two occupations who were deemed to perform some similar functions.

Table 7
Views about how successful tax inspectors are at particular activities

	A	*AC*	*FD*	*IA*	*B*	*J*	*Chi²*
Diagnosing problems	*Not significant at 5% level*						
Prescribing remedies to problems	*Not significant at 5% level*						
Acquiring information	5.0	5.1	5.1	5.3	5.5	5.3	24
Coping with risk and uncertainty	*Not significant at 5% level*						
Predicting the future	*Not significant at 5% level*						
Publicising their services	1.9	2.3	2.5	2.6	2.4	2.6	11
Making a profit	2.5	2.9	3.4	3.7	3.8	3.9	18
Detecting errors and irregularities	4.5	4.7	4.5	5.0	5.4	4.9	59
Preventing errors and irregularities	*Not significant at 5% level**						
Complying with professional rules	4.8	4.7	4.8	5.5	5.7	5.5	35
Enforcing legal requirements	5.8	5.7	5.7	6.1	6.2	5.8	33
Forming correct judgements	*Not significant at 5% level*						
Acting independently without regard to self-interest	5.3	5.2	4.7	4.9	5.0	5.1	13
Communicating effectively	3.8	4.0	3.6	3.5	3.2	2.8	30
Reporting truthfully	5.2	5.2	5.1	5.0	5.7	5.4	21
Being even-handed with the interests of others	*Not significant at 5% level*						
Limiting their own legal responsibility	*Not significant at 5% level*						
Providing a useful service to clients	2.8	3.0	3.0	3.4	3.4	4.4	22
Providing a useful service to society	*Not significant at 5% level*						

Above means based on the seven point scale: 1 = Extremely unsuccessful, 4 = Neither successful nor unsuccessful and 7 = Extremely successful.
A = Auditor, AC = Accountant, FD = Financial director, IA = Investment analyst, B = Banker, J = Journalist
*Difference significant at the 5% level when journalists excluded from the analysis.

Moving on from this self-rating bias, however, the results do not provide much support for the claim that the audit expectations gap revealed by our survey is simply the product of a general downward biasing against professions. With the exception of financial journalists (see below), the responses of the other occupational categories show clear discriminating patterns and rankings regarding the relative performance of auditors, tax inspectors and solicitors. A somewhat surprising finding emerges from the responses of financial directors. Although they ranked auditors higher than tax inspectors on most activities, the financial directors only ranked auditors' performance as higher than that of solicitors on three categories—giving solicitors a significantly higher ranking on nine activities. Even stronger comparative scores were provided by investment analysts and bankers (rating the performance of solicitors to be significantly better than that of auditors on 10 and 12 activities respectively). The only activity at which auditors were seen as outperforming solicitors is that of publicising their services, a potential reflection of the growing commercialisation of the accounting profession. Investment analysts and bankers rated the performance of auditors and tax inspectors more evenly on the various activities (bankers rating each significantly better on five activities, with investment analysts rating auditors significantly better on six activities and tax inspectors on seven activities). Again, though, there are clear patterns in the rankings, with tax inspectors being rated significantly better at enforcement functions (including activities such as detecting errors and irregularities, enforcing legal requirements and acting without self interest). Auditors were ranked more highly on entrepreneurial activities such as making a profit and publicising their services. Their services were also regarded as comparatively more beneficial to clients but less beneficial to society. Clearly, there may be some expected conflict between client and societal

Table 8
Views about how successful solicitors are at particular activities

	A	*AC*	*FD*	*IA*	*B*	*J*	*Chi²*
Diagnosing problems	4.8	4.5	4.6	4.2	4.3	4.2	18
Prescribing remedies to problems	4.9	4.7	5.0	4.6	4.5	4.6	19
Acquiring information	5.2	4.8	5.1	5.0	4.7	4.5	21
Coping with risk and uncertainty	4.1	3.9	4.1	3.4	3.8	3.5	18
Predicting the future	3.4	2.9	3.2	2.9	3.3	2.8	16
Publicising their services	3.7	4.0	4.3	4.0	3.7	4.1	25
Making a profit	5.9	5.8	6.2	6.0	5.9	5.9	22
Detecting errors and irregularities	4.2	4.0	4.1	4.4	4.4	4.4	12
Preventing errors and irregularities	*Not significant at 5% level*						
Complying with professional rules	6.0	5.8	5.8	6.0	6.0	5.1	23
Enforcing legal requirements	6.0	5.7	5.8	6.0	6.0	5.4	14
Forming correct judgements	5.3	5.0	5.1	4.9	4.8	4.2	32
Acting independently without regard to self-interest	5.2	5.0	4.7	4.5	4.4	3.3	58
Communicating effectively	4.6	4.5	4.6	4.6	4.2	3.4	28
Reporting truthfully	5.8	5.4	5.3	5.3	5.3	4.1	44
Being even-handed with the interests of others	5.0	4.8	4.7	4.4	4.4	3.5	38
Limiting their own legal responsibility	5.5	5.6	5.9	6.1	5.7	6.1	21
Providing a useful service to clients	*Not significant at 5% level*						
Providing a useful service to society	5.0	4.7	4.6	4.6	4.7	3.7	18*

Above means based on the seven point scale: 1 = Extremely unsuccessful, 4 = Neither successful nor unsuccessful and 7 = Extremely successful.
A = Auditor, AC = Accountant, FD = Financial director, IA = Investment analyst, B = Banker, J = Journalist
*Difference not significant at the 5% level when journalists excluded from the analysis.

demands, but interestingly both bankers and investment analysts (as well as financial directors) rated solicitors to be better than auditors in serving both clients and society.

Some evidence of a downward professional bias was evident in the responses of financial journalists, with few significant differences being obtained from their comparative rankings of solicitors and auditors. They were more discriminating in their responses' evaluations of tax inspectors, who were seen in a relatively favourable public service, less entrepreneurial light.

Factor analysis of the auditing activity

The above analysis of the semantic differential testing instrument focused on comparative rankings and differences across particular audit activities. With 19 potential audit activities it becomes somewhat difficult to retain a sense of position as to what factors are driving the differences across occupational groups. To facilitate such positioning, factor analysis was conducted of the various groups' views as to how successful auditors are at particular activities. Using a varimax rotation method (SPSSx, 1986), this produced between four and six orthogonal factors for the different groups (with each factor having an eigenvalue greater than one). Table 11 lists the various factors produced, together with all component items with factor loadings greater than 0.60.

The cumulative percentage of the variation explained by the factors for each occupational group ranged from 54.2% to 73.9%. We have subjectively named the various factors in an attempt to find a description that best reflects the concept shared by each factor's component items. A number of the factors that were seen to underlie audit activities were common to most groups—including independence, problem solving, compliance, commerciality and analysis/investigation. What is striking is the significance of the independence factor—rated as the most powerful discriminatory

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SINGLE-PAGE Impression

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…auditors and tax inspectors at various activities

	A	AC	FD	IA	B	J
	a	a	a			
	a	a	a	a	a	
	a	a		t	t	
	a	a	a		a	
	a	a	a			
	a	a	a	a	a	a
	a	a	a	a	a	a
	a			t	t	t
	a	a	a			t
	a	a	a			
		t	t	t	t	t
	a	a	a			
…to self-interest	a			t	t	t
	a	a	a	a	a	
	a	a	a		t	t
	a	a	a		a	t
	t	t				
Providing a useful service to …	a	a	a	a	a	
Providing a useful service to society			t	t	t	t

a = auditors' performance at a particular activity ranked significantly higher than that of tax inspectors.

t = tax inspectors' performance at a particular activity ranked significantly higher than that of auditors.

All reported differences are significant at the 5% level using the Wilcoxon signed ranks test. Spaces indicate insignificant difference.

Table 10

Views about the comparative success of auditors and solicitors at various activities

	A	AC	FD	IA	B	J
Diagnosing problems	a	a	s			
Prescribing remedies to problems			s	s	s	s
Acquiring information	a	a				
Coping with risk and uncertainty	a	a				
Predicting the future	a	a	s	s		
Publicising their services	a	a	a	a	a	
Making a profit	s	s		s		
Detecting errors and irregularities	a	a	a			
Preventing errors and irregularities	a	a	s		s	
Complying with professional rules				s	s	
Enforcing legal requirements	s	s	s	s	s	s
Forming correct judgements	a	a	s	s	s	
Acting independently without regard to self-interest	a	a		s		
Communicating effectively				s	s	
Reporting truthfully	a	a		s	s	
Being even-handed	a	a	a			
Limiting own legal responsibility	s	s	s	s	s	s
Providing a useful service to clients	a		s	s	s	
Providing a useful service to society	a		s	s	s	

a = auditors' performance at a particular activity ranked significantly higher than that of solicitors.

s = solicitors' performance at a particular activity ranked significantly higher than that of auditors.

All reported differences are significant at the 5% level using the Wilcoxon signed ranks test. Spaces indicate insignificant differences.

Table 11
Factors of Auditing

Auditors	*Accountants*	*Analysts*	*Bankers*	*Directors*	*Journalists*
Factor 1: Independence	*Factor 1: Independence/Service*	*Factor 1: Independence*	*Factor 1: Independence*	*Factor 1: Problem Solving*	*Factor 1: Disinterest*
0.78 Being even-handed	0.71 Forming correct judgements	0.86 Being even-handed	0.81 Being even-handed	0.71 Diagnosing problems	0.84 (Not) Making profits
0.76 Reporting truthfully	0.70 Serving clients	0.81 Acting independently	0.79 Acting independently	0.70 Predicting the future	0.79 Being even-handed
0.72 Acting independently	0.68 Serving society	0.80 Reporting truthfully	0.76 Reporting truthfully	0.70 Coping with risk	0.61 Acting independently
	0.63 Acting independently	0.66 Serving society	0.64 Communicating effectively	0.66 Prescribing remedies	0.60 Predicting the future
Factor 2: Problem solving	*Factor 2: Analytical*	*Factor 2: Problem solving*	*Factor 2: Problem solving*	*Factor 2: Independence*	*Factor 2: Compliance*
0.73 Prescribing remedies	0.75 Coping with risk	0.84 Prescribing remedies	0.84 Diagnosing problems	0.78 Being even-handed	0.88 Complying with professional rules
0.65 Serving clients	0.73 Diagnosing problems	0.81 Diagnosing problems	0.81 Prescribing remedies	0.74 Acting independently	0.67 Enforcing legal requirements
		0.63 Communicating effectively	0.67 Coping with risk	0.74 Reporting truthfully	0.66 Detecting errors
		0.61 Predicting the future	0.61 Communicating effectively	0.65 Communicating effectively	0.61 Reporting truthfully
Factor 3: Compliance	*Factor 3: Compliance*	*Factor 3: Compliance*	*Factor 3: Compliance*	*Factor 3: Commerciality*	*Factor 3: Problem solving*
0.71 Enforce legal requirements	0.85 Enforce legal requirements	0.69 Enforce legal requirements	0.80 Comply with professional rules	0.74 Making profits	0.83 Prescribing remedies
0.63 Preventing errors	0.81 Comply with professional rules	0.68 Limiting responsibility	0.62 Acquiring information	0.68 Publicising services	0.79 Diagnosing problems
		0.64 Comply with professional rules			
Factor 4: Prediction	*Factor 4: Communication*	*Factor 4: Prediction*	*Factor 4: Commerciality*	*Factor 4: Compliance*	*Factor 4: Dissemination*
0.74 Predicting the future	0.75 Communicating effectively	0.72 Predicting the future	0.75 Making profits	0.75 Enforcing legal requirements	0.82 Communicating effectively
0.64 Coping with risk	0.60 Reporting truthfully	0.67 Coping with risk	0.70 Publicising services	0.69 Complying with professional rules	0.71 Limiting responsibility
				0.61 Service to clients	
Factor 5: Investigation	*Factor 5: Commerciality*	*Factor 5: Commerciality*	*Factor 5: Limiting Liability*		*Factor 5: Investigation*
0.83 Acquiring information	0.80 Publicising services	0.72 Making profits	0.86 Limiting own responsibility		0.76 Acquiring information
	0.77 Making profits	0.64 Publicising services			0.75 Coping with risk
Factor 6: Commerciality	*Factor 6: Limiting Liability*				*Factor 6: Marketing*
0.79 Publicising services	0.73 Limiting own responsibility				0.84 Publicising services
0.78 Making profits					

Cumulative percentage of variation explained by factors:

factor in three of the six groups, with modified independence factors rated top in two other groups. The reference to a modified factor is important because there is a clear pattern in the nature of the 'independence' factor associated with each occupational group. The accountant respondents recognise a greater service element in the independence factor than auditors, whilst the emphasis placed by financial directors on service is reflected in the problem solving capacities of the audit function being their most discriminatory factor (ahead of independence). Bankers' and investment analysts' responses reflect an independence factor of a similar nature and influence to that of auditors. Financial journalists, however, reveal a far tighter notion of independence, which stresses the significance of not making profits. To reflect such distinctions this was labelled as a 'disinterest' rather than an 'independence' factor.

The implication of the results of the factor analysis is that the audit expectations gap would appear to be centred heavily on notions of auditor independence, and the tensions between an independent, compliance based audit function and a creative, problem solving, consultative function. The different extremes of financial directors and financial journalists also point clearly to the non-uniform nature of the expectations gap. Such findings do not augur well for the possibility of closing the gap. In responding to the demands of management for problem solving and consultative functions (as has been the trend in recent years—see Humphrey and Moizer, 1990), auditors would appear to be doing little to meet (and potentially even to be exacerbating) concerns over independence and the disinterested nature of the audit reporting function.

Views About Likely Actions that Auditors Would Take in Specific Case Studies

The results of comparison between the groups of respondents to the six cases[8] are presented in Table 12. The cases attempted to examine perceptions about what auditors do with reference to specific circumstances rather than to the more generalised assertions reported earlier. Essentially the cases covered three main points: the contribution of reporting by auditors to the general accountability of enterprises; whether non-auditors expect auditors to do more detailed work than is auditors' normal practice; and the effect of client pressure on auditors' behaviour. Cases were devised around some of the more controversial issues to have been discussed recently in relation to both audit reporting (e.g. reporting in the public interest) and the extent of audit work (e.g. concerning the audit of overseas subsidiaries, an issue raised in the Polly Peck affair). All the cases produced significant differences (although the case of auditors reporting insider dealing to the regulatory bodies was not significant when journalists were excluded from the analysis).

The cases involving reporting covered two issues (insider dealing and public health) and two forms of reporting (directly to regulatory authorities and in the audit report on the financial statements), on which comparison between groups can be made. All groups thought it more likely that auditors would report directly to regulators in the insider dealing case than in the public health case. Financial journalists had the lowest expectations of auditors reporting in any form. With this exception, the insider dealing case produced little difference between groups on reporting to a regulatory authority but, while all groups thought this more likely than an audit report comment, the auditors and accountants had lower expectations than the other groups of the latter. On the public health issue, the non-auditor/accountant groups generally thought the likelihood of reporting to regulators similar to that of comment in the audit report. In contrast, auditors and accountants had lower expectations of reporting to regulators but higher expectations of an audit report comment. These differences may reflect different relative priorities on general accountability and financial statement responsibilities. Auditors' and accountants' views on an audit report comment may be related to the possibility of a contingent liability affecting the financial statements.

Of the cases concerned solely with the extent of audit work, the largest difference arose from the question of the number of secondary audits to be investigated by the primary auditor. Auditor respondents expected the auditors to do much more audit work than was expected by others.[9] This result does not lend support to the suggestion that users have an outmoded vision of auditors diligently checking every detail of a company's accounting records. Of all the evidence collection cases, it was only in relation to the vouching of fixed assets that some of the user groups felt that auditors would do comparatively more work than that expected by the auditor respondents. Even here, the scale of divergence, whilst significant statistically, was not of a magnitude to suggest that

[8] Details of the six cases are available from the authors on request.

[9] Interpretations of the responses to the subsidiary audit case study are complicated as the case raises questions about the confidence that can be placed in the work of the subsidiary auditors as well as in the willingness of the primary auditors to investigate. Hence, it is possible to argue that the observed differences are due either to the auditor respondents expecting that auditors will do more work than the other occupational groups would imagine or to the other groups having more confidence than the auditor respondents in the work of secondary auditors.

Table 12
Views about the likely actions that auditors would take in specific case studies (for details of each case see the Appendix)

	A	AC	FD	IA	B	J	Chi^2
Insider dealing							
Likelihood of the auditors referring to the matter in the audit report	20%	26%	33%	27%	41%	13%	60
Likelihood of the auditors reporting the matter to the appropriate regulatory body	55%	53%	51%	50%	56%	35%	16*
Pressure to do no further work							
Likelihood of the auditors carrying out work without charging an additional fee	67%	62%	50%	46%	36%	26%	145
Likelihood of the auditors resigning from the audit	39%	38%	41%	37%	48%	25%	28
Pressure to conceal information							
Likelihood of the auditors reporting to the appropriate public health body	22%	24%	37%	36%	41%	29%	59
Likelihood of the auditors referring to the matter in the audit report	45%	44%	39%	37%	35%	23%	20
Attendance at stock-takes							
Number of warehouse stock-takes that the auditors will attend**	1.8	1.8	1.8	1.5	1.1	0.7	50
Vouching of fixed asset purchases							
Percentage of purchases to be checked to invoices	40%	44%	48%	54%	51%	39%	22
Checking secondary auditors' work							
Number of secondary audits to be investigated**	3.4	3.1	2.0	1.5	0.9	1.1	142

A = Auditor, AC = Accountant, FD = Financial Director, IA = Investment analyst, B = Banker, J = Journalist.

*Differences not significant at the 5% level where journalists excluded from this analysis.

**Mean responses; maximum 6 stock-takes and 6 secondary audits respectively.

user groups had totally unrealistic expectations of the extent of audit work.

The largest difference from all the cases was produced by the evaluations of the likelihood of the auditor doing necessary work unpaid in the face of client pressure not to. Auditors and accountants had high expectations that the work would be done (67% and 62% respectively), finance directors and investment analysts lower (50% and 46% respectively), bankers lower still (36%), with financial journalists most sceptical (26%).

Conclusion

The questionnaire survey has revealed a wealth of detail of how auditors and some of the main participants in the company financial report process differ in their views as to the nature of auditing and the work that auditors do. The large number of statistically significant differences and the relatively high explanatory power of the one variable of occupational group membership confirms quite clearly that an audit expectations gap exists—and exists on a variety of aspects of the nature of the audit function and the perceived performance of auditors. There is little evidence to suggest that the gap is the consequence of a general downward biasing against professions, nor would it appear that user groups hold wildly unrealistic views of the extent of audit work.

The survey confirms that the critical components of the expectations gap as at the start of the 1990s include the auditor's role in relation to fraud detection; the extent of auditor's responsibility to third parties; the nature of balance sheet valuations; the strength of, and continuing threats to, auditors' independence; and aspects of the conduct of audit work (for example, auditors' ability to cope with risk and uncertainty). The results of the factor analysis of activity constructs provide evidence of the prevalence of independence related

attributes in assessments of the contribution and quality of auditing.

The persistence of expectations problems surrounding auditing historically casts doubt on the possibility of fully closing the gap, but we hope that the results of this survey, by providing empirical evidence of the differences between auditors and others in how they see the activity of auditing, can contribute to a better understanding of the nature and significance of the gap, and help to promote action by the auditing profession to respond to the views of those relying on the work of auditors.

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Auditors' Liability: Its Role in the Corporate Governance Debate

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Abstract—The purpose of this paper is to examine the role of auditors' liability in the context of the corporate governance debate currently taking place in the United Kingdom. Much of the current dissatisfaction with the role of auditing may be attributed to an apparent tension between the economic and legal interpretations of the auditor's risk sharing role. There are powerful economic motives for both company management and other stakeholders to seek an extension of auditors' liability. This paper argues against an extension of liability to third party audit users. It is suggested that such a move would create difficulties in the auditor-client relationship, accentuate moral hazard problems associated with third party litigation and lead to a restriction in the availability of professional indemnity insurance. Ultimately, the effect is likely to be a reduction in the availability of audit services, especially to high risk companies such as new ventures and participants in the market for corporate control.

Introduction

The quality of corporate governance is presently a matter of considerable concern in the United Kingdom. Recent corporate failures have initiated a widespread debate on the effectiveness of existing systems of governance with stakeholders, particularly shareholders and creditors, expressing dissatisfaction with the current state of corporate accountability. Although concern about the effectiveness of corporate governance is not new, the present debate is particularly focused on the low level of confidence in corporate financial reporting (Committee on the Financial Aspects of Corporate Governance, 1992, p. 14). An integral part of the financial reporting process is the statutory audit which has traditionally provided independent verification of corporate disclosures. Recent research, however, provides evidence of audit user dissatisfaction with the role and responsibilities of auditors (Humphrey *et al.*, 1992; City Research Group, 1991). In addition, stakeholders in a number of failed companies have initiated litigation against auditors in the hope of obtaining recompense for their losses (*Financial Times*, 1992).

Dissatisfaction with auditor responsibility concerns two separate, but related, issues: the extent of auditor investigation and to whom auditors should be liable. Recent interest in the former has manifested itself in the question of the auditor's responsibility for the detection of fraud (Sikka *et al.*, 1992) and the effectiveness of auditing standards (Sikka, 1992). The second area of concern is the extent of the auditor's liability to audit users, specifically those parties not in a contractual relationship with the auditor. This paper is concerned with the extent of auditor liability, primarily focusing on the likely implications of expanding liability to third party audit users.

The auditor's risk sharing role

An Economic Model

The modern corporation is typically presented as a nexus of contracts between the various factors of production (Jensen and Meckling, 1976; Fama and Jensen, 1983a and 1983b). In order to facilitate such contracting, mutually observable information is required by all contracting parties. Implicit in the contractual view of the firm is the existence of information asymmetries between the firm's management and the other contracting parties, providing opportunities for management to issue biased reports in order to maximise their own wealth at the expense of other stakeholders. Such information asymmetries suggest a demand for independent auditing (Watts and Zimmerman, 1983). Audited financial statements are perceived to transmit a positive signal to audit users regarding the accuracy of management's disclosures, thus enabling stakeholders to contract with increased confidence (Committee on the Financial Aspects of Corporate Governance, 1992, p. 36). One consequence of this reliance is that the auditor may be exposed to loss in the event of the audited financial statements being inaccurate and consequently unreliable. The ability of corporate stakeholders to sue the auditor for compensation arising from reliance on inaccurate financial statements has led to the suggestion that the auditor may have an important risk sharing role (Wallace, 1980 and 1987).

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Under statute, the company is primarily responsible for the published financial statements. It follows that directors and senior executives are exposed to liability in the event of the statements being inaccurate. Risk averse directors and officers are expected to seek protection from such liability. This may be achieved in a number of ways. First, managers may seek to include an element of risk premium in their remuneration in order to provide against future liability payments. Second, managers may insist, as a condition of accepting their appointment, that the company arranges some form of indemnity to provide for future liability payments. A typical example is the purchase of a Directors' and Officers' Insurance policy. Third, due to the operation of joint and several liability, managers may be able to share their reporting liabilities with the auditor. Wallace (1980) suggests that auditors may provide managers with more effective protection against liability claims than a conventional insurance company. This arises due to the value which both auditors and managers attach to the reputation asset (Fama, 1980). The ability to enjoin the auditor in the defence of allegations of manager negligence increases the probability of the manager emerging with his reputation intact. Of course, the addition of an auditor also helps to cushion the manager from adverse liability payments in the event of the negligence allegations being confirmed.

Other corporate stakeholders, particularly investors, may also view the auditor as an effective method of sharing risk. When contracting with a company, stakeholders face two risks: the possibility of the company failing and thereby being unable to honour its contracts, and the possibility of the firm's published financial statements being inaccurate and therefore unreliable. Stakeholders are able to counter the former risk by transacting with a suitably diversified portfolio of companies. The ability to sue the auditor may be a method of circumventing the possibility of incurring losses due to unreliable financial statements (DeJong and Smith, 1984). In addition, stakeholders are aware of the likelihood of managers being unable to meet liability awards from their personal resources. Thus, the presence of an auditing firm with 'a deep pocket' may appear more attractive to contracting parties. This risk sharing role of auditing is consistent with Bar-Yosef and Livnat's (1984) hypothesis that companies making new issues switch to larger auditing firms. Of course, by using auditors in this way, stakeholders attempt to obtain insurance against business risk which is unavailable in the conventional insurance market.

The Legal Interpretation

The risk sharing view of auditing assumes a legal environment in which auditors may be held liable to a wide range of corporate stakeholders. In the UK, however, the courts presently refuse to accept that the auditor may owe a duty of care to parties other than its client (Caparo Industries v. Dickman and Others, 1990; James McNaughton Paper Group v. Hicks Anderson & Co., 1991). This represents a significant narrowing of auditor liability compared to the early 1980s, when the courts appeared more willing to recognise third party rights (JEB Fasteners Ltd. v. Marks Bloom & Co., 1983; Lloyd Cheyham & Co. Ltd. v. Littlejohn & Co., 1985). The present restrictive interpretation of auditor liability suggests a tension in the corporate accountability mechanism. By instituting a system of compulsory auditing and requiring the publication of the resulting audit report, legislators appear to have acknowledged the information value of the audit process. However, by depriving the majority of audit users of the ability to enforce their expectation of reliable financial statements, the courts have raised serious doubts about the true value of the mandatory audit. This apparent paradox suggests a number of issues which need to be addressed. First, why have the courts felt that auditors should be shielded from extended liability? Second, does the absence of a third party liability sanction remove the auditor's incentive to perform satisfactory auditing?

Initially the courts appeared to justify their reluctance to expose auditors to third party liability from an economic point of view. Perhaps the most forthright expression of this view was provided by Judge Cardozo who, in the US case of Ultramares v. Touche (1931), warned against exposing auditors to a liability indeterminate in amount, for time and to class. Recent UK courts, however, have exempted auditors from liability on the basis of the objective of the statutory audit. The courts have argued that the primary purpose of the audit is to facilitate shareholder monitoring of management and not to provide information to assist third party decision-making.

The present thinking of the courts is best illustrated by the case of Caparo Industries v. Dickman and Others (1990). The case is well known, but in essence, Caparo, an existing Fidelity shareholder, alleged that it had relied on Fidelity's audited accounts when deciding to make a take-over bid for Fidelity. When the take-over was complete, Caparo claimed that Fidelity's accounts had over-valued the company and sued the auditors for reimbursement of its losses. The House of Lords decided that no duty of care was owed to Caparo by Fidelity's auditors. The judges maintained that the main function of the audit is to examine the directors' financial statements on behalf of shareholders, enabling shareholders to evaluate the performance of company management. It was held that auditors owe a duty of care to company shareholders as a whole, but not

individually. The judges concluded that Caparo had used the audited accounts purely to decide whether to make a take-over bid for Fidelity. Since the audit was not prepared for this purpose, no duty of care was owed.

In two subsequent cases alleging third party reliance on audited financial statements the courts have endorsed the Caparo doctrine. In James McNaughton Paper Group Ltd. v. Hicks Anderson & Co. (1991), auditors had prepared draft accounts which were to be used specifically for the purpose of take-over negotiations. In the wake of the Caparo decision the Court of Appeal refused to accept that the auditors owed a duty of care to the eventual purchaser, despite the plaintiff's argument that they belonged to a class of persons whose reliance on the draft accounts could have been foreseen by the auditor. The case of Berg Sons & Co and Others v. Adams and Others (1992) sought the court's view on whether auditors owe a duty of care to creditors. In refusing to accept the plaintiff creditor's claim, the court emphasised the inability of the plaintiffs to prove that the audit was performed for a purpose other than to satisfy the statutory audit requirement.

The courts' determination to confine auditors' liability to shareholders as a group raises concern about the role of auditor liability in corporate accountability. In particular, the courts' apparent belief that shareholders as a group are capable of monitoring management may be unrealistic. Much of the recent corporate governance literature suggests that shareholders, even in the presence of reliable financial statements, are unlikely to monitor company management effectively (Oviatt, 1988). It has been suggested that managerial discipline may be achieved through a variety of internal and external mechanisms, such as incentive contracts and the market for corporate control (see Walsh and Seward, 1990 for a detailed review). In their recent pronouncements, the courts appear to have excluded auditor compensation in the event of such monitoring. The concern is that by interpreting the duty of care so narrowly the courts have effectively exempted auditors from liability sanction. The question then arises as to whether sufficient incentives exist, without liability, to maintain adequate audit quality.

Goldberg (1988) argues that the need to maintain the auditor's brand name is an effective deterrence mechanism. Audit clients use the auditor's brand name as an element of a strategy to encourage parties to enter into financial transactions. Obviously, if the quality of the auditor's work is perceived to deteriorate, then the audit client will be expected to switch to an auditor with a better brand name in order to maintain its attractiveness to contracting parties. In this way, the efficient working of the audit market imposes a quality incentive on the auditor, in the absence of third party liability. However, it is suggested that reputation effects may be an ineffective monitor of auditor quality because of audit user difficulty in differentiating quality auditors without recourse to litigation (Chapman, 1992).

In a similar vein, Gwilliam (1992) suggests that the courts may believe that typical third party audit users do not require judicial protection. It is argued that third parties who may be concerned about audit quality are capable of protecting their interests by entering into a contractual arrangement, either with the auditor or with the company, whereby it obtains compensation in the event of the financial statements being unreliable. There is little evidence to suggest that third parties have negotiated such contracts, suggesting their satisfaction with the present level of audit quality. In addition, the courts may also be mindful of the type of third parties who are most likely to benefit from an extension in auditor liability. The vast majority of plaintiffs are likely to be financial institutions, trade creditors or other companies involved in merger or take-over activity. All these are sophisticated parties, capable of instituting sufficient safeguards to protect their interests, without the court's assistance.

There continues to be some divergence between the economic need for accurate and reliable corporate financial information and the courts' reluctance to impose an onerous degree of liability on auditors. Of particular interest is the relationship between auditing quality and liability. An important implication of the current legal interpretation is the difficulty in obtaining insights into the quality of audit work, since third party plaintiffs must first convince the court that a duty of care exists, before the specific question of auditor negligence can be addressed. This process effectively prevents judicial interpretation of audit quality in a third party context. The absence of first party cases of auditor negligence fails to provide any further indication regarding audit quality. Of course, what we are unable to ascertain is the extent to which cases such as Caparo have encouraged auditors to relax the quality of their auditing. However, the extent of current audit user criticism suggests that audit quality is far from satisfactory. Whether extending liability to third parties is a solution to the present dissatisfaction is critically examined below.

The implications of extending auditor liability

This section discusses the likely consequences of extending auditors' liability to third party audit users, as has been suggested in the wake of Caparo and other recent court decisions (e.g. *Financial Times*, 1993). It is argued that such a development is likely to be counter-productive for a number of

reasons. First, the ability of company management to share its disclosure liabilities with the auditor is likely to compromise the auditor's ability to perform an effective and independent audit. Second, the *ex post* and *ex ante* moral hazards associated with third party claims suggest that auditors may become insurers for audit users' business risk. Third, the uncertainty associated with the size, frequency and source of third party claims is likely to impair the auditors' ability to purchase insurance protection. In addition to the loss of the valuable risk transfer function, professional indemnity insurers also provide valuable monitoring of audit quality through the auditing professions' compulsory insurance schemes.

Prior to addressing these concerns individually, it is important to understand the status of the various parties in the auditing process. The judges in Caparo clearly interpreted the purpose of the statutory audit as a means by which shareholders, as a group, may evaluate management's stewardship of their company. Therefore, it would appear that the auditor's client is the company, as represented by the shareholders, who legally appoint the auditor and agree its remuneration at general meeting (ss. 384–385, Companies Act 1985). Consequently, for the purposes of this article, 'third parties' is deemed to refer to all parties other than shareholders as a group and the company itself. Similarly, the term 'management' refers to the directors and senior executives of the audited company, essentially those parties who are legally responsible for preparation of the company's financial statements.

The Auditor-Management Relationship

An extension of liability to third parties is likely to have a significant effect on the auditor-management relationship. The courts' present interpretation of the extent of auditor liability effectively prevents company management from utilising the principle of joint and several liability to share its reporting liabilities with auditors. An important consequence of this is the need for management to remain vigilant in the preparation of its financial disclosures. It is also in management's interest to co-operate fully with the auditor since a thorough audit reduces the probability of erroneous disclosures and consequent stakeholder litigation. In an extended liability environment, such an equilibrium is unlikely to hold. By allowing company management to share its third party liabilities with auditors, financial statement responsibility is likely to shift from company management to the auditor, reflecting an increased emphasis on error detection rather than on error prevention, which presently appears to be the case.

Even though management's ability to share liability would still be dependent upon third parties being able to prove auditor negligence, the inclusion of auditors in the defence process is welcome news for management who are well aware of auditors' insurance-assisted wealth and determination to preserve their reputation (O'Sullivan, 1993). Indeed, prior to Caparo and the resulting endorsement of restricted liability, the Likierman Committee concluded that the operation of joint and several liability resulted in auditors having to bear an unfair share of financial statement related litigation (DTI, 1989, p. 25). Additionally, questions of auditor negligence typically arise when their client company is experiencing financial difficulty. For example, Palmrose (1987) found that over fifty per cent of instances of auditor litigation in the US arose from business failure. Recent experience in the UK would seem to endorse this finding. A primary reason for this is that the auditor is likely to be the only party with its wealth intact and consequently is a logical target for stakeholder litigation. The present restriction on third party litigation appears to prevent auditors being disadvantaged in this way.

The inclusion of auditors in the defence of third party actions is likely to threaten the auditor's ability to perform an effective audit. In particular, company management are encouraged to reduce their level of care and willingness to co-operate in the audit process. Careless reporting may be influenced by management's desire to reduce internal control costs or it may be a deliberate attempt to issue unreliable information in order to obtain more advantageous contracts with stakeholders. Nelson *et al.* (1988) model the likely impact of liability on auditor and management effort. They suggest that an extension in auditor liability is likely to result in a decrease in management care and a commensurate increase in auditor effort. A key question, therefore, is whether the auditor is capable of effectively countering management's expected reduction in care by increased effort.

Although the auditor may be able to counter the problem of unintentional disclosure by performing more extensive auditing, in the case of deliberate misstatement, however, greater effort is unlikely to increase significantly the probability of detection. Management who wish to deceive will obviously bear the audit in mind when perpetrating the act and will consequently design its deceit precisely in order to avoid auditor detection. Even in circumstances where management is not attempting to deceive the auditor, more extensive auditing may not be entirely effective. In particular, once a certain level of audit effort is reached, diminishing marginal returns suggest that further auditor input may be ineffective. The main device available to auditors in seeking to improve audit quality is to increase the number of audit hours spent on each engagement. This may be achieved either by increasing staff numbers or by increasing the amount of time spent on each audit assignment. If

more staff are deployed on a particular job the quality of supervision may decline, whilst spending an extended period on each engagement means that the resulting financial information, even though more accurate, may be stale and may not be of much use to audit users (Goldwasser, 1988). In either case the risk of litigation is not substantially reduced while the cost of the audit would almost certainly increase reflecting the additional effort undertaken. However, it may be difficult for auditors to pass this increased cost on to their client companies. Obviously company management are expected to keep audit costs as low as possible. In an expanded liability environment increased auditor effort is primarily initiated by the auditor's desire to escape third party litigation. Therefore, it is difficult to see how management would be prepared to increase company costs to help protect the auditor from such liability.

Indeed, a realignment of liability between auditor and management places client management in a very strong negotiating position. We have seen how the auditor is encouraged to audit with increased care in order to minimise liability exposure. We have also seen how difficult it may be for the auditor to convince management that an increase in the audit fee may be justified. In addition, although the appointment of the auditor is legally a matter for the shareholders in general meeting, client management enjoy *de facto* discretion in deciding whether a particular auditor is retained. Studies of auditor litigation have consistently highlighted the increased risk of litigation when a detailed review of the auditor's work is initiated, such as in the case of business failure (St. Pierre and Anderson, 1984; Palmrose, 1987), or management change (Lys and Watts, 1992). In a third party liability environment, auditor switching is likely to result in the conduct of a similar review. Obviously, an audit firm in the first year of an engagement is encouraged to examine the work of its predecessors in order to eliminate the threat of future litigation resulting from the previous auditor's negligence. It is not surprising, therefore, that an incumbent auditor, aware of the increased probability of litigation once replaced, may be more receptive to management's wishes. In this way, management's leverage on the auditor is enhanced, which is likely to undermine the independence of the audit process.

Third Party Litigation

The recent cases of third party litigation against auditors have centred on the existence of a duty of care. The conservative nature of the courts' decisions have frequently prevented such cases from proceeding any further. In an extended liability environment third party litigation is more likely to be concerned with questions of audit quality than with the extent of third party reliance. Of particular importance, therefore, is the courts' ability to decide whether a particular audit has been negligently performed and whether the third party plaintiffs have suffered genuine loss because of the auditor's negligence.

In professional liability actions against auditors there is no agreement as to what constitutes an acceptable degree of audit care. Although the requirements for a minimum statutory audit are prescribed in the Companies Acts, the company and its auditor are free to negotiate additional contractual duties. In addition, over the years the courts have implied into audit contracts certain responsibilities not specified in statute, such as the auditor's responsibility in relation to fraud (see Gwilliam, 1992, and Godsell, 1991, for a more detailed discussion). In addition, auditing standards provide the courts with some guidelines as to the quality of auditing desired (Lloyd Cheyham v. Littlejohn, 1985). Despite this, auditing involves a significant amount of auditor subjectivity. If a claim is based on an auditor's professional judgement, there is little way of knowing whether the auditor's choice of method and level of care will be acceptable to the court. In addition, professional liability claims are described as being 'long tail', in that a significant period may elapse between the filing of a claim and its eventual settlement. Therefore, the auditor needs to be aware of the possibility that work done today may not reach decision for another ten years (Woolf, 1990), when the determinants of auditor negligence may have changed substantially.

An extension of liability introduces both *ex ante* and *ex post* moral hazard problems for the auditor. Obviously a third party, who suffers loss when an auditor's client becomes insolvent or suffers a reduction in its share price due to the disclosure of financial irregularities not discovered during the audit process, has a strong *ex post* incentive to exaggerate his reliance on the audit in an effort to recover losses from the auditor. The extent of third party reliance on an audit report is difficult to measure and almost always will consist of nothing more than the plaintiff's representation that he relied on the audit rather than on other factors when deciding to contract with the audited company. Such ambiguity places an enormous burden on the capacity of the legal system to differentiate between business risk and audit error (Jurinski, 1987). Even if it is possible to evaluate the merits of the plaintiff's claim, assessing the amount of loss attributable to the auditor's negligence is very difficult, particularly when such claims relate to changes in share valuations (Anderson, 1977; Anderson and Pincus, 1984).

Of great importance to auditors is the increased possibility of *ex ante* moral hazard. Specifically, those parties who contract with audited companies and who previously used a variety of risk

assessment techniques before deciding whether to transact, are now tempted to rely exclusively on the accuracy of the audited financial statements as a means of assessing the company's financial health. The third party in the triangular relationship between the company and the auditor is aware of the increased possibility of being able to blame the auditor for any losses suffered as a result of risks not exposed by the audit report. Thus, a rule allowing third party recovery against auditors creates incentives for third parties to relax their own risk management methods at the auditor's expense. Again the onus is placed on the courts to differentiate between audit and business risk. Even though the UK courts have warned against plaintiff's undue reliance on the auditor's work (Lloyd Cheyham v. Littlejohn, 1985), in an extended liability environment the expected increase in the number of plaintiffs may impair the courts' ability to isolate auditor error.

Availability of Insurance

A common justification for extending auditor liability is the belief that auditors are capable of socialising their increased liability via the insurance function. Indeed, in one particular US case the court explicitly cited the auditor's ability to purchase insurance as one reason for justifying the imposition of third party liability (Rosenblum v. Adler, 1983, cited by Goldberg, 1988). Although the ability of product manufacturers to socialise their third party liability via insurers has enabled a liberal duty of care to be developed (Priest, 1985), in the case of auditing this is unlikely to function so well. In particular, there is reason to believe that an extended liability environment would seriously affect the availability of insurance.

In order for insurance markets to operate effectively, insurers need to be capable of estimating the level of losses from each insured. At present, professional indemnity insurers employ a number of underwriting techniques in order to make quality differentiations amongst audit firms. In addition to obtaining information on the auditor's previous claims history, insurers are also interested in, *inter alia*, the qualifications and experience of the auditor, supervision within the practice, the practice's size and client portfolio, as well as whether the practice is over-reliant on one client or a small number of clients. In this way insurers are capable of obtaining some indication of the proposer's litigation potential. In a third party liability environment, quality differences amongst audit firms would be extremely difficult to identify. First, an extension in liability affects auditors as a class, therefore increasing the probability of litigation for all auditors. Second, in order to obtain an insight into the probability and likely extent of litigation, the underwriter needs to be capable of monitoring the characteristics of the auditor's clients, particularly evaluating their third party exposures. The difficulties of undertaking such monitoring may make the provision of auditor insurance uneconomical for the insurer. The insurer's problems are further compounded by the potential for widespread reliance on the auditor's work, which ultimately determines the insurer's liability exposure.

The most likely result of such uncertainty is that insurers will withdraw from the auditor professional liability market. Recent work by Hogarth and Kunreuther (1992) examined the reactions of underwriters in such an uncertain underwriting environment. Their research indicates that underwriters react defensively, typically by withdrawing from that particular insurance market claiming that either the losses which they face are incalculably large, or the probability of occurrence was no longer actuarially predictable. This is no trivial matter. Goldberg (1988) notes that, between 1983 and 1988, the number of insurers writing auditors' professional indemnity business declined from twelve to three. Such a decline coincided with the acceptance of third party liability in some states in the US. Similar concerns were instrumental in the Department of Trade and Industry establishing the Likierman Committee in 1988 to examine the cost and availability of professional indemnity insurance in the UK.

The unavailability of insurance protection also affects the auditing profession's self-regulation strategy. The Companies Act 1989 (s. 24) introduced into UK law the Eighth EC Company Law Directive whose objective was to 'secure that only persons who are properly supervised and appropriately qualified are appointed company auditors'. In order to conform with the requirements of the Act auditors must demonstrate an ability to satisfy professional liability claims. In accordance with the Act the UK accountancy bodies have introduced compulsory insurance schemes. In addition to enabling auditors to satisfy professional liability claims, compulsory insurance also provides valuable external monitoring of auditor quality. Insurers' underwriting techniques impose financial penalties on those auditors who are perceived to be of low quality. In addition, the compulsory insurance schemes provide for the withdrawal of practising certificates from those auditors unable to obtain insurance protection. Therefore, the potential unavailability of insurance protection is likely to remove insurers' specialist monitoring of auditor quality which may further reduce the quality of corporate disclosures.

Auditors' defensive strategies

The previous section has shown how an extension in auditor liability to third parties creates serious problems for auditors. It is therefore expected

that auditors will seek methods of alleviating their increased liability burden. The purpose of this section is to explore the defensive strategies available to auditors in an extended liability environment. It is suggested that auditors may pursue two types of defensive strategy. First, they may attempt to use their input into the auditing standard setting process to reduce the overall level of expected audit quality. Second, auditors may attempt to reduce their liability exposure at the individual client level. Of particular interest in this respect is the possible use of minimal contractual terms, audit qualifications and greater client selectivity. However, in order to be effective such defensive strategies face two problems: acceptance by the courts at the overall level and the ability to ascertain high risk clients at the individual level.

Auditing Standards

Sikka (1992) argues that the UK auditing profession has traditionally enjoyed considerable autonomy in the formulation of auditing standards. In addition, case law suggests that the courts frequently refer to evidence of accepted audit practice when determining audit quality (Lloyd Cheyham v. Littlejohn, 1985). It appears, therefore, that auditors may be capable of defining the standards under which they operate. However, any attempt by the auditing profession to use their domination of the standard setting process would almost certainly be unacceptable to the courts. Indeed, in the US case of Hochfelder v. Ernst & Ernst (1976) the court explicitly warned the auditing profession against setting unacceptably low standards. In addition, such action may encourage the government to review the present self-regulation privileges of the auditing profession.

Auditors are not totally powerless in their ability to influence overall audit quality. As seen earlier, one of the auditor's biggest problems is the subjective nature of the audit process. Indeed, St. Pierre and Anderson (1982) document that a very high percentage of litigation against auditors involves the misrepresentation of professional standards. It is therefore in auditors' interests to attempt to make auditing standards more uniform. By reducing choice in accounting methods, auditors can take an element of the uncertainty out of the audit process. Such a move is also likely to be more acceptable to the courts.

Client Contracting

In addition to attempting to limit their liability exposure at the overall quality level, auditors may also be expected to explore a number of client-specific defensive strategies. Perhaps the most obvious method by which the auditor may seek to limit liability exposure is by negotiating low quality audit contracts with clients. However, this strategy is unlikely to succeed for a number of reasons. First, an extension of liability would be an expression by the courts of the public welfare attributes of the audit process. The courts are unlikely to endorse a contract which seeks to circumvent this. Second, the courts are unlikely to enforce a standard of auditing which is below that prescribed by statute. Third, the Companies Act 1985 (s. 310) explicitly prevents an agreement between the company and its auditor which seeks to limit the auditor's liability arising out of its statutory responsibilities.

Fogarty *et al.* (1991) suggest that auditors are expected to issue more non-standard or qualified opinions in an extended liability environment. Qualified opinions effectively insulate the auditor from third party liability since the audit report specifically mentions that the accompanying financial statements do not represent a 'true and fair view' of the firm's financial position. In a recent US study, Kothari *et al.* (1988) found some tentative evidence that increased qualification has been a reaction to the worsening malpractice position of accountants. However, whilst qualifications are undoubtedly a method of reducing liability exposure, their effectiveness depends on two factors: the competitiveness of the market for auditing services and the ability of auditors to qualify appropriately.

Obviously a qualified opinion is unwelcome for the auditor's client. Consequently, management are expected to exert substantial pressure on the auditor in an attempt to avoid qualification. Research into the relationship between qualified audit reports and auditor switching lends support to this assertion (Craswell, 1988). The decision facing the auditor is whether to qualify and risk the loss of the contract or to preserve its relationship with the client. In a third party liability environment it is expected that the equilibrium will shift in favour of qualification as the potential litigation loss exceeds the audit fee sacrificed. Interestingly, significant evidence exists, particularly in relation to the going concern qualification, that auditors do not accurately issue such qualifications (Barnes and Huan, 1993; Citron and Taffler, 1992). This apparent inability to predict corporate failure suggests that auditors may be unable to utilise the qualification option in order to avoid liability, since Palmrose (1987) found that the majority of cases against auditors arose from corporate failure.

It appears that the most effective defensive strategy available to the auditor is to select clients more carefully. Increasingly the audit profession is being urged to bear future liability in mind when accepting audit assignments (Hall and Renner, 1988; Murray, 1992). Up to now client selection processes may have been thwarted by the supplementary advisory services which often accompany an audit contract. However, recent US

evidence suggests that auditors are becoming more selective in the clients which they accept (Johnson and Higgins, 1991). Such a strategy is likely to have a number of consequences in the audit market. First, auditor selectivity is most likely to discriminate against small, rapidly growing companies who are most in need of auditing, both from an internal control point of view and also in order to maintain credibility with their stakeholders. Second, as recent litigation indicates, firms active in the market for corporate control present a particular hazard for auditors. It is likely that the increased potential for third party claims will encourage auditors to consider whether auditing such clients is worth the risk. Third, in addition to the level of third party exposure of clients, it is expected that the auditor also considers the complexity of a company's business prior to accepting a particular engagement. The amount of overseas business transacted by the company, difficulties in verifying stocks and/or asset values and the extent of regulation required in a particular industry, are all likely to influence the auditor's decision process.

Conclusion

Auditor liability is an important issue in the present corporate governance debate. Recent research provides evidence of audit user dissatisfaction with the role and responsibility of auditors. Such dissatisfaction is focused on the extent of auditor liability, primarily as a result of recent court decisions which appear to restrict auditors' liability to third party audit users. Not surprisingly, many audit users have called for legal change to allow third party liability. The main purpose of this paper has been to examine the feasibility of such a demand.

It is suggested that much of the current audit user dissatisfaction may be attributed to an apparent inconsistency between economic and legal interpretations of the auditor's role. There are powerful economic motives for both company management and other stakeholders to seek an extension of auditors' liability. However, this paper argues that such a move would be counterproductive. A number of difficulties are identified. First, an extension of liability would create difficulties in the auditor-client relationship. This arises because company management are expected to utilise the principle of joint and several liability in order to share their liabilities with the auditor. It is suggested that such a sharing of liability is likely to affect the auditor's effectiveness and independence. Second, the existence of third party litigation introduces uncertainty into the liability claims process. In particular, there is increased potential for *ex ante* and *ex post* moral hazard, making it difficult for the courts to identify whether losses claimed arise from auditor negligence or from normal business risks for which third party plaintiffs should not be entitled to recover from the auditor. Third, due to uncertainty regarding the size and frequency of claims, an extension of liability is likely to result in a restriction in the availability of insurance protection. In addition to its risk sharing properties, auditors' professional indemnity insurers provide valuable quality monitoring via the auditing profession's compulsory insurance schemes.

The ultimate result of increased third party liability is likely to be a severe restriction in the availability of auditing services. Such a defensive strategy is likely to discriminate particularly against those companies who are perceived to be high risk, such as growth companies and companies participating in the market for corporate control.

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Factors Affecting the Formation of Audit Committees in Major UK Listed Companies

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Abstract—This research investigates the proposition that there are differences between companies which have voluntarily formed audit committees and those which have not. The results of univariate and multivariate tests reveal statistically significant differences between the two groups for variables representing: (i) agency costs of equity, (ii) agency costs of debt, and (iii) director pressure to reduce information asymmetries.

Introduction

The report of the Committee on The Financial Aspects of Corporate Governance (Cadbury Committee, 1992) places great emphasis on the importance of a properly constituted audit committee and recommends (p. 28) that 'all listed companies should establish an audit committee'. The reasons for this are based largely upon the widely held view that audit committees are best practice.[1] However, a mandatory approach has been criticised. Leading figures who expressed disquiet over this feature of the Cadbury Report include: Sir Owen Green of BTR plc,[2] who suggested that audit committees are divisive; and Robin Leigh-Pemberton, the governor of the Bank of England,[3] who was concerned that the recommendations might be interpreted as a division rather than distribution of responsibilities. The theoretical arguments against audit committees are summarised by Bradbury (1990) who points out that the requirement for companies to operate an audit committee can: (i) impose costs unevenly across companies if differences exist between companies in the costs and benefits of monitoring packages; (ii) lead to companies transferring resources from existing, and perhaps more effective, monitoring activities on the assumption that monitoring expenditure is limited; and (iii) prevent companies from signalling information by the choice of an audit committee as a monitoring mechanism.

Despite these criticisms, Collier (1992, p. 57) found that at January 1991 65% of the top 250 UK listed companies had voluntarily formed an audit committee. This paper seeks to discover whether audit committees are randomly distributed among major UK companies and, if they are not, to identify possible reasons why some companies have formed audit committees while others have not. The results are compared with the findings from similar work in the US and New Zealand.

Progress in the UK towards mandatory audit committees

Audit committees are not a new concept,[4] but in the UK the overwhelming majority of audit committees have come into existence since 1980 (Collier, 1992, p. 59). Nor can audit committees be viewed in isolation; rather they are part of a wider discussion on corporate governance and are inextricably linked with discussions on the role and duties of non-executive directors. The connection arises partly because audit committees involve and empower non-executive directors and partly in response to the need for improved audit, financial control and financial reporting. Recent pressure in this direction prior to the Cadbury Report has come from:

> *Companies (Audit Committees) Bill 1988*
> The bill aimed at giving shareholders the power to insist on the appointment of audit committees and non-executive directors. The

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[1] Marrian (1988, p. 8) reported that 1978 was the peak year for audit committee formation and that the peak appears to have arisen from a fashion perhaps created by the Consultative Committee of Accountancy Bodies intimating to the UK government that experimentation with audit committees by companies should be encouraged. The results of Collier (1992, p. 69) supported these findings by reporting that 'good corporate practice' was the dominant motive for companies having an audit committee.

[2] Green, Sir Owen, 'Why Cadbury leaves a bitter taste', *Financial Times*, 9 June 1992, p. 19.

[3] Analysis, 'Cadbury report: an acquired taste', *Accountancy Age*, 18 June 1992, p. 8.

[4] Tricker (1978, p. 14) quotes a 'Report of the Audit Committee' of the Great Western Railway dated 1872.

bill was defeated in the Lords after successfully completing the committee stage. The defeat was attributable to a reluctance to legislate in this area rather than an antipathy towards the concept of audit committees.

Interested Bodies
Various bodies, for example the Institute of Directors,[5] have called for legislation or regulation to require listed companies to have an audit committee; the revised PRO NED code (1987) had similar provisions to assist non-executive directors in carrying out their tasks; and the ICAEW (1991) contained a recommendation on audit committees and set out details of their composition and functions.

International Influences
Both the Treadway Commission (National Commission on Fraudulent Financial Reporting, 1987) in the US and the MacDonald Commission (Commission to Study the Public's Expectations of Audits, 1988) in Canada recommended an expansion of the role of audit committees and have been cited in the UK debate.

Overall, there has been a consistent message from relevant quarters that audit committees are to be encouraged.

Previous research into audit committees

Research into audit committees falls into three categories: (i) surveys of the extent to which companies have an audit committee; the composition, practices and procedures of audit committees; and opinions on audit committees and matters related thereto; (ii) studies testing hypotheses on the effectiveness of audit committees; and (iii) studies attempting to explain why some companies have audit committees and others do not.

Survey Research
Significant survey research into audit committees has been carried out in the UK and North America. The first survey in the UK was carried out by Tricker (1978). The project involved case study work at 15 companies. Five of the companies (33%) had an audit committee or intended to form one in the foreseeable future. A wider survey was undertaken by Chambers and Snook (1979). The population identified for sampling was the *Times* top 250 companies and 73 major financial concerns. Responses showed that 11% of financial institutions and 13% of industrial concerns had an audit committee. In 1985 Marrian (1988) investigated the formation and role of audit committees in the *Times 1000* industrial companies: 451 replies were received and 17% of respondents indicated that they had an audit committee. In 1991 Collier (1992, p. 169) revealed that the number of organisations with an audit committee had grown steadily. Two-thirds of the UK companies, including virtually all the financial institutions, reported the existence of an audit committee.

The developments in the UK lag those in North America. Mautz and Neumann (1970, 1977) carried out the first US studies of audit committees. The 1970 survey showed that 32% of the companies responding had an audit committee; and the 1977 findings (just before the NYSE made an audit committee a listing requirement) were that 88% of companies had an audit committee. In Canada, Lam and Arens (1975) reported that in 1971 only 6% of a sample of major Canadian companies had audit committees. However, following federal legislation in 1975 and provincial legislation throughout the 1970s, the number of companies with audit committees grew. In 1980 a survey (CICA, 1981) found that audit committees were widespread.

The surveys in the UK and North America demonstrate that audit committees in these countries are fairly homogeneous as regards their composition, procedures and functions.

Research Into the Effectiveness of Audit Committees
The majority of such research emanates from the US. Grinaker *et al.* (1978) approached the effectiveness problem by asking senior executives, audit partners, heads of internal audit and audit committee members to rate a number of effectiveness criteria. The diligence of the audit committee members was the factor that was most highly correlated with effectiveness and was the most dominant characteristic in explaining variations in assessment of overall effectiveness. The knowledge base of the audit committee was also a highly rated factor. Reinstein (1980) developed a normative model through translating the ten Generally Accepted Auditing Standards into a conceptual framework for the duties and responsibilities of audit committees. The conclusion reached was that most audit committees were effective in terms of the conceptual framework. Birkett (1980) asked audit committee members and external auditors to rate the effectiveness of the audit committee in carrying out certain functions. Both groups suggested that audit committees were reasonably effective in carrying out key functions. A less positive result was obtained by Jackson-Heard (1987) who concluded that the audit committee does enhance the perception of auditors' independence but not to a marked degree.

[5]*Financial Times*, 'IOD Backs Pressure for Non-Executive Board Appointments', 23 November 1990, p. 7.

Research Into Why Some Companies Have Committees and Others Do Not

Information on differences between companies with and without audit committees was obtained as a by-product of various surveys. For example Kunitake (1981) and Campbell (1982) investigated the effect of the audit committee on the selection of the external auditor and particularly whether firms with audit committees changed to Big Eight auditors. No statistically significant results emerged. However, more positive results were obtained by Eichenseher and Shields (1985). The researchers compared two groups of American Stock Exchange companies. One group had changed external auditors and the other had not. The researchers found that: (i) although all companies were moving towards selecting Big Eight auditors, the trend was more pronounced for companies with audit committees; and (ii) companies that changed auditors were more likely to form audit committees if the successor auditor was a Big Eight firm.

Three projects have addressed the problem specifically. Crawford (1987), in an examination of a sample of American Stock Exchange companies, found no support for a link between a company having or not having an audit committee and the following variables: changes in accounting policy; qualified audit opinions; changes in external auditors; and litigation concerning financial reporting involving the directors, officers or auditors. Pincus *et al.* (1989) used an agency theory framework to analyse the reasons for forming audit committees. The resultant hypotheses were examined using a random sample of NASDAQ over-the-counter companies. Six characteristics were found to be associated with the voluntary formation of audit committees: (i) lower percentage of managerial ownership; (ii) higher leverage; (iii) larger firm size; (iv) a greater proportion of outside directors to total directors; (v) Big-eight auditors; (vi) participation in the National Market System (therefore among the most actively traded NASDAQ securities). The research demonstrated a clear link between firms with high agency costs and the voluntary formation of audit committees. Bradbury (1990) approached the same problem using the functions of audit committees as a framework in a study of 135 firms listed on the New Zealand Stock Exchange. The findings show that the voluntary creation of audit committees is not related to auditor incentive variables or agency costs derived from the separation of ownership and control. However, there is a relationship between voluntary audit committee formation and director incentives: both the number of directors on the board and the existence of a major outside shareholder were found to be strongly related to a firm having an audit committee. The research results of Pincus *et al.* and Bradbury are contradictory. The former found that 68% of a random sample of US corporations listed on NASDAQ had voluntarily formed an audit committee, whereas the latter concluded that in a 'purely voluntary environment, very few firms form audit committees'. Further, Bradbury disagrees with Eichenseher and Shields (1985) and Pincus *et al.* (1987) in finding no link between Big Eight auditors and the formation of audit committees. The explanation may lie in cultural differences between New Zealand and the US or merely relate to the limited coverage of the research.

Hypotheses

Agency Costs

Wallace (1980) discussed how auditing can reduce agency costs which derive from the inherent conflicts of interests between principals and agents (Jensen and Meckling, 1976). Audit committees ensure audit quality and thus improve the effectiveness of monitoring. Therefore, an audit committee will be formed provided the associated costs are lower than the benefits in the form of lower agency costs. It may also be anticipated that the pressure for the formation of audit committees will be greatest in high agency cost situations. As Pincus *et al.* (1989) pointed out: 'audit committees will be voluntarily employed in situations of high agency cost to enhance the quality of information flows between principal and agent'.

Shareholder-Manager Conflict

Watts (1977, pp. 57–59) and Leftwich, Watts and Zimmerman (1981, pp. 56–62) contend that external reporting is instrumental in reducing conflict between shareholders and managers. As the number of shareholders increases so does the opportunity for conflict and the importance of external reporting. A key function of audit committees is the independent review of external reporting (Collier, 1992, p. 171). Therefore:

> H1 *Ceteris paribus*, there is a positive relationship between the number of shareholders and the existence of an audit committee.

Jensen and Meckling (1976) and others have argued that the degree of conflict between managers is inversely related to their respective ownership interests. As shareholders' interests increase, the potential agency costs of equity increase, and this will lead to price protection by shareholders. This reaction by shareholders will encourage managers to increase monitoring activity through mechanisms like audit committees as the managers' ownership of the firm decreases. Therefore:

> H2 *Ceteris paribus*, there is a negative relationship between the directors' ownership of the equity of the company and the existence of an audit committee.

Debtholder-Manager Conflict

Fama and Miller (1972, p. 145) argue that debtholder-manager conflicts give rise to agency costs of debt. Jensen and Meckling (1976), Watts (1977) and others argue that agency costs of debt increase as gearing increases. Higher gearing levels lead to debtholders price protecting themselves and these actions give managers the incentive to improve monitoring, perhaps through the formation of audit committees. In this context, the role of audit committees would be to restrict the opportunities for management to switch accounting methods to avoid breaching covenants in lending agreements (Holthausen and Leftwich, 1983, reported that firms which are close to their accounting-based debt restraints may switch to accounting methods which alleviate the problem). Therefore:

> H3 *Ceteris paribus*, there is a positive relationship between the level of gearing of a company and the existence of an audit committee.

Myers (1977) analysed the value of the firm into assets-in-place and assets yet to be acquired (growth opportunities). Leftwich, Watts and Zimmerman (1981, p. 61) observed that the benefits of monitoring depend upon asset structure, as wealth transfers between shareholders and debtholders are more difficult for firms with a greater proportion of assets-in-place. Thus, the agency costs of debt are higher for companies which have considerable growth opportunities than for those with a greater proportion of assets-in-place. Following the argument put forward for gearing, increased monitoring through audit committee formation may be a reaction from management in firms with a low proportion of the asset structure in the form of assets-in-place. Therefore, it may be hypothesised that:

> H4 *Ceteris paribus*, there is a negative relationship between the value of assets-in-place and the existence of an audit committee.

Economies of Scale in Monitoring Costs

Pincus *et al.* (1987) argued that, given the homogeneity of structure and functions of audit committees, the net benefits derived from economies of scale are greater for larger firms. Collier (1992, p. 170) reported that there was reasonable consistency in the structure, practices, procedures and scope in the wide variety of companies in the UK. While there is support for the economies of scale contention in the US, where Mautz and Neumann (1977, p. 4) reported a widespread belief amongst those surveyed that company size was a crucial factor in influencing a company to form an audit committee, survey results in the UK are mixed. Marrian (1987, pp. 37–38) found that 73% of the *Times 1000* respondents with an audit committee were in the top 250 companies, but Collier (1992, p. 57) reported no association between top 250 position and the existence of an audit committee. This suggests that, in the largest UK companies, economies of scale in monitoring costs are not a significant factor but outside this group such costs are important. Therefore:

> H5 *Ceteris paribus*, there is a positive relationship between the size of a company and the existence of an audit committee.

The board of directors is a monitoring device on behalf of shareholders (Fama, 1980, p. 294). In particular, as the Cadbury Committee argued, non-executive directors, being independent of the company's officers and executive directors, fulfil a crucial monitoring role. The effectiveness of the board and non-executive directors as monitoring devices is limited due to information asymmetries between the executive and non-executive directors. Non-executive directors will have a personal stake in reducing information asymmetries for two reasons: (i) through agency cost incentives in order to fulfil their responsibilities to shareholders, and (ii) to reduce their legal liability. In the UK, the position on directors' liability has changed radically recently due to the Companies Acts 1985 and 1989, the Insolvency Act 1986 and the Company Directors Disqualification Act 1986. Nor is liability limited to executive directors: the decision in *Dorchester Finance Co Ltd v Stebbbing*[6] suggests that the same level of skill may be required of both executive and non-executive directors depending on their individual experience and qualifications. Indeed, the liability for non-executive directors could be significant, especially in the case of corporate failure, as experience and qualifications are major considerations in the selection of non-executive directors, who are increasingly assumed to fulfil a monitoring role. Audit committees provide an effective way of reducing information asymmetries between executive and non-executive directors, and it may be anticipated that non-executive directors will pressure the company to form one. Therefore:

> H6 *Ceteris paribus*, there is a positive relationship between the number of non-executive directors on the board and the existence of an audit committee.

Dominant Chief Executive

Forker (1992) stated that corporate governance devices, such as audit committees, create pressure for better disclosure which is resisted by dominant personalities on the board. A similar argument could be employed to suggest that dominant personalities might block the formation of audit com-

[6][1980] 1 Co Law 38.

mittees as these might constrain their freedom. Therefore:

> H7 *Ceteris paribus*, there is a negative relationship between the existence of a dominant executive director on the board and the existence of an audit committee.

Competition Between Auditors

The literature argues that audit committees strengthen the independence of auditors (Wolnizer, 1987, p. 155). Therefore it may be supposed that all auditors will encourage the formation of audit committees. However, Eichenseher and Shields (1985, p. 25–28) report that auditors outside the Big Eight were unlikely to press for the formation of an audit committee because they believed an audit committee would favour the appointment of a Big Eight firm. A study by Lynn (1985, p. 12) also supports a positive relationship between Big Eight auditors and the existence of an audit committee. A similar position may be expected in the UK, although recent mergers have reduced the Big Eight to a Big Six. Therefore:

> H8 *Ceteris paribus*, there is a positive relationship between a company being audited by a Big Six firm and the existence of an audit committee.

Population, sample, variables and data collection

Research by Marrian (1987) and Collier (1992) suggests that audit committees occur most frequently in the largest companies and therefore this research focuses on these. The population was defined as UK based companies quoted on the Stock Exchange in the top 250 of the *Times 1000* (Allen, 1989). After the elimination of companies which had been taken over or had ceased to trade, there was a residual population of 167 companies. It was decided to collect data for all the companies in the population using a combination of questionnaires, financial statements[7] and other sources. The questionnaires[8] were despatched in early 1991 and responses were received from 142 companies (85% response rate). Tests for non-response bias suggested that the respondents were representative of the population. The following variables were used in testing the hypotheses:

Dependent Variable

For the purposes of this paper, an audit committee was defined as a committee of the board comprising at least two non-executive directors with primary functions which include a review of the financial statements and a review of the findings of the external auditors. The existence of an audit committee (AC) was defined as one operating at 1 January 1991. This information was obtained from the questionnaire. AC is coded 1 if an audit committee is operational; otherwise AC equals 0.

Predictor Variables

H1. Information on the number of shareholders (NoSHS) was collected by the questionnaire and represents an improvement on Bradbury (1990) who used the total number of shares issued by the firm as a proxy.
H2. The extent of directors' ownership (DIROWN) was obtained from the financial statements. DIROWN was measured as the ratio of the sum of beneficial and non-beneficial interests of directors in equity to total equity.
H3. Gearing (GEAR) was obtained from the financial statements and defined as the ratio of liabilities payable in over one year to firm size.[9]
H4. Assets-in-place (AIP) was obtained from the financial statements and defined as the ratio of fixed assets to firm size.[9]
H5. Firm size (SIZE) was measured as the sum of the market value of equity and the book values of preference capital, debt and current liabilities.[9] The data on market values was obtained from the London Business School (1991, pp. 23–31). The second quarter issue for 1991 was chosen as being closest to the mid-point of the year from which the financial statements used were made up to.
H6. Number of non-executive directors (NoNEDS) was obtained from the financial statements.
H7. Dominant personality (DOMCE) was defined as one director holding the roles of chairman and chief executive. These details were obtained from the financial statements. DOMCE is coded 1 if the chairman and chief executive are the same person; otherwise DOMCE equals 0. The proxy chosen for a dominant personality follows Forker (1992) and reflects the Institutional Shareholders Committee (1991, p. 2) who stated that 'The combination of the roles of Chairman and Chief Executive constitutes a concentration of power and can give rise to conflicts'.
H8. Big Six auditor (BIG6) was obtained from the financial statements. BIG6 is code 1 if the auditor is a member of the Big Six; otherwise BIG6 equals 0.

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[7]The financial statements had year ends in 1991.

[8]The data was collected in the course of a survey of companies conducted for the Institute of Chartered Accountants in England and Wales and the Bank of England as described in Collier (1992).

[9]The same definition was used in Pincus *et al.* (1989). Bradbury (1990) defined gearing as the ratio of total liabilities to the firm size defined as the market value of ordinary share capital and the book values of preference shares and debt.

Table 1
Descriptive statistics and univariate tests relating to the predictor variables

Hypothesis	*Direction*	*Variable*	*Companies with an AC (n = 89)* *Mean*	*Companies without an AC (n = 53)* *Mean*	*Univariate test result (1-Tailed probability)*
H1	+	NoSHS	0.112	0.044	MWU z = 1.4052 p = 0.0800
H2	–	DIROWN	0.016	0.070	MWU z = 3.6387 p = 0.0002
H3	+	GEAR	0.151	0.124	MWU z = 1.7673 p = 0.0336
H4	–	AIP	0.310	0.308	MWU z = 0.3332 p = 0.3695
H5	+	SIZE*	0.492	0.311	MWU z = 1.9529 p = 0.0254
H6	+	NoNEDS	4.888	3.245	MWU z = 5.0424 p = 0.0000
H7	–	DOMCE	0.360	0.396	X^2 1df 0.064 p = 0.3983
H8	+	BIG6	0.955	0.849	X^2 1df 3.5515 p = 0.0293

*Multiplied by 10^{-8}.

Variable description and univariate tests

Of the 142 companies responding to the survey, 89 (63%) had an operational audit committee at 1 January 1991. Table 1 contains the basic descriptive statistics related to the predictor variables and the results of tests of association. Tests of association were based on the Wilcoxon-Mann-Whitney (MWU) test[10] for continuous variables and on the Chi-squared test for dichotomous variables.

The differences between the means are in the direction predicted except for AIP which has means marginally in reverse to the hypothesised direction. The MWU tests reject hypothesised differences between companies with and without audit committees at a 10% level of significance for AIP and DOMCE. The outcome for the assets-in-place ratio probably reflects the deficiencies in the accounting valuations inherent in the fixed asset part of the ratio. Dominant personality may similarly suffer from the suitability of the variable used to measure the phenomenon, as an individual may well dominate the board without being both chairman and chief executive.

At the 10% level the NoSHS was significant. The finding suggests that audit committees exist in situations where there are high agency costs of equity due to widespread shareholdings. At the 5% level GEAR, SIZE and BIG6 were significant. The Big Six auditor result supports the findings of Eichenseher and Shields (1985, pp. 25–27) that small auditors will not encourage the formation of audit committees as these are perceived as favouring Big Six auditors. At the 1% level, the NoNEDS and DIROWN are significant. The relationship between this proxy for the agency cost of equity conforms with the expectation that the shareholders are the primary constituency of the board and suggests that the directors' ownership of voting shares is a better proxy for the agency cost of equity, possibly because the number of shareholders variable is distorted by privatisation companies.

Table 2 shows that, although none of the correlations is very strong, there are linear relationships between some combinations of NoSHS, NoNEDS, DIROWN, SIZE and AIP at the 10% level of significance. The intercorrelation between the variables means that the univariate results may be mis-stated. Therefore the hypotheses were re-tested using a multivariate approach in order that the simultaneous effect of the predictor variables on the voluntary formation of audit committees could be examined.

Multivariate tests

Logistic regression analysis is a technique appropriate when the dependent value is dichotomous. The technique requires far fewer assumptions than

[10]The non-parametric Mann Whitney U test was preferred to the parametric t test as it avoids restrictive assumptions on the distribution of the variables and according to Siegel and Castellan (1988, p. 137) has similar power-efficiency.

Table 2
Pearson correlations among the predictor variables

Variables	*NoSHS*	*DIROWN*	*GEAR*	*AIP*	*SIZE*	*NoNEDS*	*DOMCE*	*BIG6*
NoSHS	1.000							
DIROWN	0.088	1.000						
GEAR	−0.037	−0.143	1.000					
AIP	0.311*	0.011	−0.163	1.000				
SIZE	0.575*	−0.117	−0.138	0.036	1.000			
NoNEDS	0.246*	−0.218*	−0.091	−0.048	0.332*	1.000		
DOMCE	0.131	0.050	−0.024	−0.026	0.125	−0.019	1.000	
BIG6	0.086	−0.123	0.140	0.080	0.135	0.108	0.077	1.000

* – significant at less than or equal to 0.10.

discriminant analysis and performs well (Aldrich and Nelson, 1990, p. 54). To reduce skewness in the data, NoSHS and SIZE were subject to a natural logarithmic transformation.

The Logit model is in the form:

$$\begin{aligned} \mathrm{LOGIT(p)} = {} & B_0 + B_1\mathrm{NoSHS} - B_2\mathrm{DIROWN} \\ & + B_3\mathrm{GEAR} - B_4\mathrm{AIP} + B_5\mathrm{SIZE} \\ & + B_6\mathrm{NoNEDS} - B_7\mathrm{DOMCE} \\ & + B_8\mathrm{BIG6} \end{aligned}$$

where p is the probability that AC = 1 (probability that there is an audit committee).

The results of the logistic regression analysis are shown in Table 3. The signs associated with logistic regression coefficients are in the predicted directions with the exception of SIZE which is negatively associated with the probability that there is an audit committee. The model correctly classifies 104 cases. It is good at predicting whether a company has an audit committee (84% correct) but is less effective at identifying companies without an audit committee (55% correct). The model anticipates more audit committees than have been formed. This outcome would not be expected if the best practice argument advanced in response to surveys was the complete picture and therefore it is probable that the best practice argument rationalises a position taken as a result of other pressures.

The observed significance levels attached to the

Table 3
Results of the Logit analysis between the dichotomous dependent variable AC and the predictor variables

Variables	*Predicted Sign*	*Coefficient*	*Significance*	*R*
NoSHS*	+	0.611	0.6672	0.0000
DIROWN	−	−4.824	0.0780	−0.0768
GEAR	+	6.832	0.0238	0.1287
AIP	−	−0.413	0.7448	0.0000
SIZE*	+	−0.013	0.7002	0.0000
NoNEDS	+	0.587	0.0001	0.2741
DOMCE	−	−0.108	0.7997	0.0000
BIG6	+	0.972	0.1833	0.0000
CONSTANT		−4.7575	0.0010	

	X^2	*Degrees of freedom*	*Significance*
−2 Log Likelihood	147.318	133	0.1871
Goodness of Fit	140.717	133	0.3068

Observed Classification	*Predicted Classification* *No AC*	*AC*	*% correct*
No audit committee	29	24	54.72
Audit committee	14	75	84.27
Overall			73.24

*Natural logarithm of the value of the variable.

−2 Log Likelihood and the Goodness of Fit statistics demonstrate that the model does not differ significantly from the 'perfect' model. At the 10% level only DIROWN, GEAR and NoNEDS are significant. The R statistic which measures the partial correlation between the dependent and independent variable confirms this position. The small values for the R coefficient related to NoSHS, SIZE, DOMCE, AIP and BIG6 indicate that these variables make little partial contributions. Director incentives are significant at the 1% level and are dominant according to the R statistic. However, the incremental changes from adding GEAR and DIROWN are significant at the 5% level (GEAR: Chi-square improvement 6.085, df 1 and significance 0.014 and DIROWN: Chi-square improvement 4.664, df 1 and significance 0.031). These results show that the GEAR and DIROWN variables which are proxying for agency costs of debt and equity are important in the decision to form an audit committee.

Summary and conclusions

The univariate and multivariate results show that there are statistically significant differences between companies with and without an audit committee.

Agency Costs of Equity

Major UK listed companies with an audit committee have a lower proportion of their share capital owned by directors. The alternative proxy for the agency costs of equity (the number of shareholders) was not significant in the multivariate model, despite the significant univariate result, because the variable was correlated with number of non-executive directors. Thus it is not wholly unimportant, as companies with large numbers of shareholders are more likely to have an audit committee, but merely subordinate to the number of non-executive directors. The findings for both directors' share ownership and the number of shareholders support the contention that the incentive to form an audit committee increases in line with the potential agency cost of equity.

Agency Costs of Debt

Major UK listed companies with an audit committee have a higher level of gearing. However, agency costs of debt were not higher for companies which have considerable growth opportunities than for those with a greater proportion of assets-in-place. Possibly this arises from problems with the valuation of fixed assets in the accounts. The findings for GEAR support the argument that the increased agency cost of debt (concomitant with higher gearing) leads to managers' improving monitoring to restrict their choice of accounting methods through voluntarily forming audit committees in order to prevent price protection from debtholders.

Director Pressure to Reduce Information Asymmetries

Major UK listed companies with an audit committee have more non-executive directors. The results suggest that audit committees are efficient in reducing the information asymmetries between non-executive and executive directors. New legislation which extends the liability of directors and agency cost incentives to reduce information asymmetries has given non-executives the motive to encourage the formation of audit committees. However, alternative explanations for this finding are possible. It could be argued that the formation of audit committees has increased the number of non-executive directors, rather than it being the steady increase in the number of non-executive directors (Bank of England 1983, 1985, 1987 and 1988) which has led to audit committees.

Economies of Scale in Monitoring Costs

The impact of economies of scale in monitoring costs were observed in the univariate results. Large companies, as measured by SIZE, were more likely to have formed an audit committee because such companies would gain greater net benefits as the costs of an audit committee are relatively fixed. Economies of scale in monitoring costs were not significant in the multivariate analysis due to significant correlation with the number of non-executive directors.

Dominant Personality

No evidence was found to suggest that dominant personalities might block the formation of audit committees. The findings indicate either that the definition used for the variable was inadequate or that audit committees do not curb the actions of these personalities.

Auditor Incentives

There was evidence that companies with auditors outside the Big Six were less likely to have formed audit committees. The findings support Eichenseher and Shields (1985) who argued that auditors outside the Big Six will be unlikely to encourage the formation of audit committees as these favour the appointment of Big Six auditors. However, the multivariate analysis suggested that this was not a significant factor.

Comparison with Previous Studies

The multivariate results are inconsistent in some respects with previous studies (Pincus *et al.*, 1989 and Bradbury, 1990) which themselves did not give a consistent picture. The study agrees with Pincus *et al.* that: (i) proxies for high agency cost situations were significant factors in the voluntary

formation of audit committees, and (ii) audit committee formation may reflect pressure from non-executive directors to reduce information asymmetries. Univariate results supported the findings of Pincus *et al.* on the size effect and the link with major firm auditors. The results are at variance with Bradbury who found no support from multivariate analysis for variables associated with voluntary accounting disclosure (number of shareholders, and gearing). However, the results concur with Bradbury in that size, major firm auditors, number of shareholders, and assets-in-place were not significant. The current study is unique in highlighting gearing as a significant factor.

The different outcomes of the three studies can probably be explained in terms of population and environmental factors. The *Times* 250 companies are not close in terms of size, international diversity and marketability with either the New Zealand population of 208 listed companies or the US NASDAQ over-the-counter firms.

Implications

The results show that the mandatory imposition of audit committees will affect disproportionately major UK listed companies with lower gearing and a higher level of share ownership by the directors. The requirement will impose additional costs on companies where price protection activities by shareholders and debtholders are insufficient for the voluntary formation of audit committees as a monitoring device or where alternative monitoring devices are preferred. Although the major UK listed companies covered by this study may not find the burden imposed by the Cadbury Committee requirement for an audit committee material, the costs of forming an audit committee among the smallest listed companies, which are likely to have a higher level of directors' share ownership and fewer non-executive directors, may well act as a disincentive to being listed.

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Financial Reporting and Corporate Accountability

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Abstract—An established and growing academic literature has developed around the view of a company as a nexus of contracts. The various implications of this literature, however, appear not to have seeped into the financial reporting and corporate accountability policy-making or policy-influencing structure in the UK. This paper addresses this tension between the theory and practice of an important aspect of corporate accountability by: (i) making a case for the explicit recognition of contracting as a legitimate role of external financial reporting; and (ii) arguing that without this there may be significant economic consequences to a variety of stakeholders and a failure to debate in terms of political realities.

Introduction

The issue of corporate accountability is undoubtedly topical, but the problems encompassed by the term are not new. Indeed, they are as old as the separation of ownership and control with its history of problems in trading off the interests of various stakeholders.[1] It is no coincidence that the role of, and justification for, financial reporting not only shares some of the same history, but stems from many of the same issues and problems.

The major focus of the paper is the examination of the impact of financial reporting on corporate accountability. The scale of this wide-ranging task is substantially limited by concentrating specifically and deliberately on just one aspect of the relationship between financial reporting and corporate accountability: the use of information contained in financial statements for contracting purposes,[2] and the economic consequences for stakeholders which may arise from this role.[3]

In the course of the paper the individual decision maker is deemed to be self-interested and primarily concerned to achieve maximum utility—the starting point for economic analysis since, at least, Smith (1776). The individual decision maker, however, is also deemed to be operating within the strictures of bounded rather than global rationality, implying that decisions and actions can have unforeseen as well as foreseen consequences.

While the role of financial reporting is, and has been, inextricably linked with the process of corporate accountability, both in academic literature and in regulatory requirements, the relationship has not been static. An early understanding of financial reporting was as a stewardship function where management act as stewards to whom suppliers of capital entrust control over their financial resources. In this context, the role of financial reporting was to provide an assessment of the stewardship of management to the suppliers of capital.[4]

From the late 1960s the emphasis in the academic literature shifted from measurement of economic income and stewardship to an information perspective,[5] a perspective which emphasises that financial reports are only one source of information from which individuals make predictions of the amount, timing and uncertainty of future cash flows. This information, or signalling, role has obvious implications for the process of corporate accountability in that it helps to reduce the information asymmetry which exists between managers and other stakeholders arising, in part, from the divorce between ownership and control.

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[1]See, for example, Adam Smith (1776/1976, p. 741) on the problems of the joint stock company.

[2]For the purposes of this paper, given its immediate policy orientation, contracts are defined in an explicitly legal sense.

[3]Stakeholders are defined to be those individuals, groups or bodies which have explicit contracts with the company such as shareholders, lenders, directors, employees, customers and suppliers. It is recognised that wider societal objectives for financial reporting have also been identified: see, for example Laughlin and Puxty (1983), Cooper and Sherer (1984). These objectives

Footnote continued

are not, however, considered within this paper, although it is recognised that they may be of significance to the process of corporate accountability in its broadest sense.

[4]Page (1991) and Whittington (1991) demonstrate the continued active interest in this portrayal of financial reporting.

[5]For example, see Beaver and Demski (1974).

An alternative, but not mutually exclusive, hypothesis to the information role for financial reporting has become established in recent years, which views a corporation as a nexus of contracts between various stakeholders. This contracting view has a well developed pedigree within not only the accounting literature but also that of economics and law.[6]

One strand of the economics literature is sometimes called the property rights perspective as it focuses upon rights established by contract.[7] A second strand investigates the agency relationship and in particular sub-optimal behaviour on the part of the agent/manager.[8]

The accounting literature has focused on accounting-based contracts (ABCs), which may be defined as contracts which include terms based upon published accounting information. They are one type of contract within the overall control process but it has been argued, notably by Watts and Zimmerman (1986), that such contracts, and therefore financial reporting itself, are integral to the overall contracting process as a means of measuring and monitoring the activities of the contracted parties in order to restrain or motivate their behaviour. Examples include: directors' remuneration contracts; lending agreements; articles and memorandum of association; some pricing contracts; taxation and other regulations.

While the contracting and informational roles are not mutually exclusive neither are they entirely compatible. The characteristics of accounting information which may be appropriate for signalling may not be equally appropriate for contracting. Given that both these roles are relevant for corporate accountability it is possible to make a case for a multi-objective approach to financial reporting regulation. The following section therefore argues that recent accounting and corporate accountability policy pronouncements in the UK have adopted a narrow perspective by largely ignoring the contracting role of financial reporting in the process of corporate accountability.

[6]See Bowles (1991) for a discussion of the law literature, and Brudney (1985) for its divergences from the economic perspective.

[7]Seminal works in this area include Coase (1937 and 1960), Alchian and Demsetz (1972), Jensen and Meckling (1976), Fama and Jensen (1983a and 1983b).

[8]For example see Berhold (1971), Ross (1973, 1974), Wilson (1968), Spence and Zeckhauser (1971), Mirrlees (1974, 1976), Stiglitz (1974, 1975), Holmstrom (1979), Antle (1982, 1984).

[9]In the academic literature there is a well developed argument for having no regulatory policy, thereby permitting companies to establish their own basis for corporate governance, own contracts and own accounting policies—see Fama (1980), Watts (1988). In the context of the UK, however, it seems unlikely that the tide of increased regulation will be reversed and the argument of the paper is therefore concerned with the form of this regulation rather than the fact of it.

A policy perspective[9]

The Accounting Standards Board (ASB) is currently engaging in a process of fundamental review of financial reporting practice in the UK, involving a re-examination of all existing Statements of Standard Accounting Practice (SSAPs) and an extension of regulation to new areas. Logically, the ASB has revisited the vexed question of the purposes of financial reporting and issued an exposure draft on the objectives of financial statements (ASB, 1991), in which it was stated that the objective of financial statements is:

> ... to provide information about the financial position, performance and financial adaptability of an enterprise that is useful to a wide range of users in making economic decisions.

The problem posed by the exposure draft is that this information role is perceived as the only objective for financial reporting.

The ASB is not alone in recognising only the informational perspective for financial reporting. The recent Report of the Committee on The Financial Aspects of Corporate Governance (1992, pp. 32–3)—hereafter the Cadbury Report—also appears only to recognise the importance of the signalling role. Other recent reports with 'official' status, e.g. Institute of Chartered Accountants of Scotland [ICAS] (1988) and Solomons (1989), have adopted a similar restrictive approach.

A recent study, jointly commissioned by the Institute of Chartered Accountants in England and Wales (ICAEW) and the ICAS—Arnold, Boyle, Carey, Cooper and Wild (1990, p. 4)—did explicitly recognise a secondary objective for financial reporting, namely:

> ... to enable the enforcement of contracts the terms of which include reference to accounting information. For example, managerial remuneration may depend in part on accounting measures and contracts with lenders may include restrictions based on accounting ratios such as the level of gearing.

Having established this secondary objective, however, there was little in the remainder of the report to say how it may be reflected in financial reports. Also, despite the fact that Arnold *et al.* (1990) preceded the ASB exposure draft and the Cadbury Report, it appears not to have been recognised subsequently in UK policy making circles.[10]

There is clearly, therefore, in the UK a stark contrast between a well developed academic

[10]This issue will be returned to later. In the interim it is worth remembering that in an oft-quoted phrase Keynes (1936, p. 384) observed that it is not uncommon '...that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest'.

literature on the contracting role of financial reporting, and the regulation of financial reporting. Not only has the ASB failed to recognise explicitly the contracting objective, but it has omitted, in terms of formal pronouncements at least, even to acknowledge the existence of the issue.

ABCs and corporate accountability

As argued earlier, ABCs can be one method of reducing the agency costs associated with a company's corporate control structure. Assuming a degree of market efficiency, however, providers of finance may be price protected. If managers do not agree to bonding activities and subsequent monitoring, then those providing debt finance could charge a higher rate of interest to compensate for expected anti-lender decisions; or, in the case of shareholders, pay a lower salary to directors in expectation of shirking. By agreeing to contractual bonding and monitoring, shareholders, lenders, managers and directors may all benefit from the more formal, and rigid, links of corporate accountability.

The success of ABCs in reducing agency costs and in establishing a binding contractual arrangement is, however, dependent upon the suitability of financial reporting to act as an adequate and reliable yardstick.[11] Thus, to the extent that financial reporting regulation evolves in a manner which reduces its suitability for contracting purposes, there will be contracting costs imposed upon companies. Before examining the nature of these potential costs for individual companies it is worth noting that evidence of the extent of such contracts in the UK exists in the context of: loan agreements (Day and Taylor, 1990), (Citron, 1992b); the dividend distribution decision (Mumford and McGee, 1988, 1990); and Stock Exchange regulations, articles of association and debenture covenants (Cleaver and Ormrod, 1992).

This evidence appears to indicate that ABCs are in widespread use in the UK; thus to fail to recognise them when drawing up financial reporting regulations may be to ignore what is *de facto* an important role for many users of this information and to disregard the contracting costs which may arise from financial reporting regulation.

The interaction of financial reporting with ABCs appears to impose contracting costs upon stakeholders in at least two ways: impact of director discretion over accounting policy choice and impact of regulation changes upon existing contracts.

[11]Neu (1991) has argued that trust must exist prior to contracting; if a yardstick cannot be trusted it is unlikely that contracts based on the yardstick will be created.

Impact of Director Discretion Over Accounting Policy Choice

Regulations which are based solely upon an informational perspective are likely to produce accounting information which may be less appropriate to the contracting process. Consequently, the role of financial reporting in reducing agency costs between the various stakeholders is likely to be hindered, thereby imposing additional costs in terms of failing to control or motivate behaviour, or in terms of additional monitoring costs as parties seek to devise other, more suitable, measures by which control can be exercised.

It is not difficult to find examples of the exercise of director discretion. Smith (1992) surveys over 200 of the largest quoted companies in the UK and highlights a number of areas where various policies have been used by companies to enhance profits or assets.[12] Despite the concern that this survey caused and the resulting calls for yet more regulation to curb this type of practice, it is not immediately obvious that they are contrary to the ASB's stated objective of providing useful information in that the study was based upon information derived from the published accounts of the companies concerned. As such, if there was any manipulation it was of an overt nature, being accompanied by sufficient disclosure to permit detection of the practice. Given our assumption of a degree of market efficiency, users of accounts would be able to make their own adjustments, based on the information provided, to allow for the effects of such techniques. Thus, from a signalling perspective there would seem to be only a weak justification for narrowing director discretion over accounting policy choice. Of course, market efficiency is an empirical question yet it is not an assumption which the ASB has begun to address in its justification of its stated policy objective.

The impact of director discretion upon ABCs may, however, be of much more concern than the signalling implications. Directors, by controlling the yardstick by which ABCs operate, may be able to effect transfers of wealth, power and risk between groups of stakeholders. Thus, in using some of the above mentioned techniques to enhance assets or income, directors may, for example, be able to: enhance profit related pay; prevent restrictive covenants in lending agreements from applying; artificially increase cost-plus based prices; and reduce taxation.

[12]Smith cites: pre-acquisition write downs; disposals; deconsolidations; deferred consideration; extraordinary and exceptional items; off-balance sheet finance; contingent liabilities; capitalisation of costs; brand accounting; changes in depreciation policy; complex capital issues; pension fund surpluses; and currency mismatching.

Impact of Regulation Changes Upon Existing Contracts

The process of fundamental review being pursued by the ASB will undoubtedly result in changing the accounting policies of many companies. From a signalling perspective, given a degree of market efficiency, this may have little impact, but there may be significant effects for some ABCs already existing at the date when new regulations are introduced because changes may cause a technical breach of a contract with resulting consequences in terms of transfers of wealth between relevant stakeholders.

ABCs can be one, or a combination, of three basic types:

(a) Rolling generally accepted accounting practice (GAAP)—where contracts are based upon changing accounting policies over time.
(b) Tailored accounting principles (TAPs)—using a set of accounting policies determined by the contract rather than those which are, or ever will be, in common use.
(c) Static (or frozen) GAAP—using GAAP as they existed when the contract was written thus involving recalculation of subsequent accounting profit to convert to base year terms.

US and Canadian research appears to provide conflicting evidence on the use of rolling GAAP.[13] In the UK, however, a recent study by Citron (1992b) on bank loan contracts found that, of a sample of 20 loan agreements where information was available, 17 used rolling GAAP with only a small minority of these imposing additional modifications or conditions.

Other contracts and regulations apart from loan agreements also use the rolling GAAP concept, if after some modification. Examples include: legal constraints on dividend payments, taxation and Stock Exchange regulations. Thus, there may be widespread and diverse effects to a change in accounting standards resulting from ABCs, but is there any evidence that such costs do actually occur?

Studies in the US have focused upon share price reactions to mandatory changes in accounting regulations, particularly as a result of covenants in lending agreements. Lys (1984) did find some weak evidence of share price reactions, but other studies[14] have failed to provide conclusive support for a significant effect on share price resulting from a change in accounting regulations. Market reaction tests can, however, be criticised as being too narrow an approach to identifying the economic consequences of regulatory change. Thornton (1992) considers the costs of effecting safeguards to covenant breaches. Additionally, costs to lenders and other stakeholders must also be considered in addition to those of shareholders.

In the UK, a current issue which serves to illustrate the wider costs associated with regulation changes is the treatment of goodwill. A recent and comprehensive review of the goodwill debate (Arnold, Egginton, Kirkham, Macve and Peasnell, 1992) analyses the main issues and proposals.[15] To summarise the evidence in this and other goodwill research, it appears that companies, no longer being permitted to retain goodwill as a permanent balance sheet item, seem to have chosen to write goodwill off immediately against reserves on acquisition.[16] For many acquisitive companies this has meant a reduction in reported net assets and therefore in book gearing.[17]

There is some evidence to suggest that this regulation change may have affected the relationship between stakeholders via the operation of three types of contract: (a) articles of association, (b) debenture trust deeds and loan contracts, and (c) Stock Exchange listing agreement requirements.

(a) Articles of association.

Within their articles of association many companies limit the extent to which the directors can commit the company to borrow without an ordinary resolution of the shareholders. The limit is normally expressed as a multiple of the published net assets of the group (Cleaver and Ormrod, 1990). The purpose of such a clause is to control the level of gearing such that the directors cannot increase the level of financial risk to which shareholders are subject without their consent. Where, however, directors have engaged in a policy of acquisitions, there may have been significant reductions in net assets arising from goodwill write offs, causing a violation of borrowing limits, even in the absence of additional borrowing. Thus, in this case, a change in accounting regulation may have shifted the balance of power from directors to shareholders by requiring shareholder sanction for even relatively insignificant amounts of borrowing, and without the directors having extended any meaningful, market value based, gearing ratio.

[13]For example see Smith and Warner (1979), El-Gazzar, Lilien and Pastena (1989), Thornton (1992), Leftwich (1983), Collins, Rozeff and Dhaliwal (1981), Frost and Bernard (1989), Press and Weintrop (1990), El-Gazzar and Pastena (1990).

[14]See Lev (1979), Collins and Dent (1979), Holthausen and Leftwich (1983), Tung (1987), Salatka (1989), Frost and Bernard (1989), Begley (1989).

[15]In this context Arnold *et al.* (1992, p. 7, p. 10) lend some further support to our contention that the contracting role should be recognised as one of the purposes of financial reporting.

[16]See for instance Tonkin and Skerratt (1991, p. 213) and Russell, Grinyer, Malton and Walker (1989).

[17]For a discussion of why companies have generally chosen not to opt for the alternative policy available under SSAP 22, of capitalising and amortising goodwill, see Grinyer, Russell and Walker (1991).

(b) Debenture trust deeds and loan contracts.

There is some evidence that debenture trust deeds and loan contracts contain restrictions on a company's power to borrow, based on gearing, in a similar manner to the articles of association's limits on directors discussed above.[18]

Thus the introduction of SSAP 22 may have shifted wealth from shareholders to lenders where such covenants were written in terms of rolling GAAP, as it enables lenders to force additional conditions arising from the breach, notwithstanding the fact that it may have arisen because of accounting regulation changes rather than the actions of the company concerned. While some lenders may waive a technical breach there is some recent evidence with respect to UK bank loans (Citron 1992a, p. 329) that a majority of banks do actually impose additional costly terms on renegotiation of contracts, despite the technical nature of the breach.

(c) Stock Exchange listing agreement requirements.

The Stock Exchange imposes a set of class tests on listed companies which are contemplating making significant acquisitions or disposals. One such test compares the published net assets of the acquiring company with the published net assets of the target company. If the latter is greater than 25 per cent of the former then the transaction needs to be approved by a general meeting of the shareholders of the acquiring company. The purpose of such class tests is to limit the power of directors to make significant acquisitions without the prior approval of the shareholders. Where, however, writing off goodwill on previous acquisitions has significantly reduced net assets it may be necessary for directors to seek shareholder approval even for relatively minor acquisitions in terms of the relative market capitalisations. Thus, the accounting regulation change with respect to goodwill may represent a significant shift in power from the directors to the shareholders in terms of this ability to make acquisitions.

ABCs and the issue of recognition

Even if the ASB accepts that financial reporting has a significant role in contracting and that there may be important economic consequences from ignoring this, it still does not automatically follow that the contracting role should be explicitly recognised in the regulation of UK financial reporting. There would appear to be at least three choices: non-recognition of contracting, *ad hoc* recognition, and formal recognition.

[18]See Lister (1985).

Non-Recognition of Contracting

Given the well developed contracting literature it is necessary to question why the ASB has failed to recognise this explicitly. Such an omission is hardly likely to be a matter of neglect. Two possible reasons may be identified: first, it would be inappropriate for regulators to act as adjudicators in political conflicts over economic consequences between stakeholders, because it could possibly produce severe problems of compliance and legitimation for the ASB; second, it would not be practical or feasible to incorporate the contracting perspective due to the difficulty of obtaining a workable consensus *within* the ASB.

With regard to the first reason, regulators are already implicitly acting as arbitrators over political conflicts arising out of contracts, irrespective of whether this is their intention. This still leaves, however, the question of explicit recognition, whereby the ASB is *seen to be* involved in the political process. There is a significant literature covering a wide spectrum of views on this issue. There is little disagreement that financial reporting *does* have economic consequences, although their precise nature may be in question. There is, however, considerable disagreement from a normative perspective as to how, if at all, regulatory bodies should consider such consequences in setting accounting standards.

At one end of the spectrum Solomons (1978, 1991) has long argued for a neutralist view of accounting, emphasising representational faithfulness and offering the view of accounting as financial cartography. Such a view does not deny the existence of economic consequences, but argues that they should not be recognised by regulatory authorities as this would endanger the integrity of accounting and the measurement techniques it incorporates.

At the other end of the spectrum can be found contributions from Hawkins (1975), Tinker (1991) and Hines (1991). Tinker and Hines challenge the Solomons view of objective reality, arguing that the 'existence' of economic reality is a function of the perceptions of an individual and is dependent on a body of 'knowledge'. As such, it is argued that it is not possible for accounting regulation to be apolitical. Hawkins argues not only that the social welfare implications of accounting regulation should be considered, but that accounting regulators—as non-elected bodies—have a democratic obligation to support the social plans of the government. To do otherwise may call into question the social legitimacy of the regulation makers.

There is an intermediate position. Rappaport (1977) has advocated what he describes as a 'mixed strategy', which represents a blend of the conceptual framework and the economic consequences approaches. This view appears to find some support from Zeff (1978, p. 63):

> The Board [FASB] is thus faced with a dilemma which requires a delicate balancing of accounting and nonaccounting variables. Although its decisions should rest—and be seen to rest—chiefly on accounting considerations, it must also study—and be seen to study—the possible adverse economic and social consequences of its proposed actions.

Such a view is broadly consistent with the contention of this paper, that the economic consequences of ABCs should at least be considered by the ASB alongside other economic consequences of accounting information. The Board's silence with respect to its own position in this spectrum of literature is worrying yet it is only part of the picture. Not only does the question of the economic consequences arising from contracts need to be considered but also the *principle* of contracting itself may be considered to be part of what Zeff described as 'accounting considerations'. Accordingly the recognition of the role and principle of contracting may be considered as a separate, and perhaps independent, question from the consideration of the economic consequences which arise from that role.

This brings us to the second of the aforementioned reasons for non-recognition, namely that it would not be feasible to set standards which are intended to accommodate the multiple roles of signalling and contracting.

Multiple objectives would appear to be a problem only where there is a sustained conflict between objectives. Frequently no such conflict would arise. The qualities which would make accounting numbers useful in an informational role are likely to be similar, in many cases, to those which would make them useful in a contracting role. To this extent, the problem of practicality would not occur. One area where it has been argued that there may, however, be a conflict between the two roles concerns the issue of certainty, or reduction in director discretion, which may be more appropriate to contracting than signalling. Yet in the ASB's brief history it appears to have adopted a stance which favours the reduction in available accounting policy choice, despite its signalling objective. Thus the adoption of contracting, far from being impractical, may provide a stronger justification, not only for what the ASB is already doing, but in further reducing discretion. In addition, the contracting perspective may offer some direction in arguments which appear to surround the issue not of whether an item should be disclosed, but of whether it should be disclosed in the notes to the accounts or in the accounts themselves. Brand capitalisation is an example of this type of contentious debate, where a contracting perspective may address the practical concerns which underpin the issue.[19]

In summary, therefore, it is argued that the ASB should recognise explicitly the role of contracting in its statement of principles and allow for the economic consequences which flow from this contracting role. Explicit recognition that such costs would be considered may, at least partially, bring the debate over contracting costs more into the open, rather than be conducted in what has been termed 'a market for excuses' (Watts and Zimmerman, 1979). It would be naive to suggest that such debate processes would cease to be conducted in terms of 'excuses' but, to the extent that contracting costs are discussed more openly, and thus the problem of self interest is being addressed, the debate would be *more* rather than *less* practical. Of course, having identified economic consequences arising from contracts, there would be no obligation on the ASB to allow such costs to affect the form of regulation in each and every case. All that is being argued is that in forming, or reforming, regulation a wider cost-benefit analysis takes place. In so doing, the costs of regulation should include the economic consequences of contracting rather than just the narrow costs of compliance. Similarly, the wider benefits arising from recognition of the principle of contracting could be considered alongside those of signalling.

It may be of course that the ASB will continue to choose not to recognise either contracts or their consequences, yet the aforementioned goodwill debate also serves to illustrate that where economic consequences are significant there will be considerable resistance by powerful interest groups to the imposing of new standards. In these circumstances it could be unrealistic to view the ASB as an exogenous, all-powerful regulatory body which is able to impose its will upon companies. Ultimately it needs some degree of consensus in order to operate.

Ad Hoc Recognition

A second approach could be to recognise contracting only on an *ad hoc* basis, i.e. on certain issues where the economic consequences of proposed regulations, or of regulation changes, are deemed significant.[20] There is some evidence that the Accounting Standards Committee (ASC)—the ASB's predecessor—did adopt an approach along these lines. MacArthur (1988) in a study of corporate responses to Exposure Drafts found specific requests by the ASC on the implications of their proposals for loan defaults in respect of ED29 (Accounting for Leases and Hire Purchase

[19] See Hopper, Kirkham and Skerratt (1992); Power (1992).

[20] This, of course, raises the additional political problem of who decides which issues have significant economic consequences.

Contracts) and ED30 (Accounting for Goodwill). In examining, however, all subsequent Exposure Drafts of the ASC, ED31 to ED55, he found no further request or recognition of this problem.

While there is a pragmatic appeal to this approach it falls short of establishing a consistent basis for all standards. Additionally, for those standards where there is no consideration of contracting costs, criticism may be levelled on the same grounds as non-recognition of the issue discussed above.

Formal Recognition

Formal recognition by the ASB may involve incorporating in its statement of the objectives of financial reporting the role of contracting, and include in its subsequent deliberations a consideration of the economic consequences which flow from that role. This formal recognition could be as a secondary objective in addition to the current information role.[21]

It is the contention of this paper that such a stance is both more honest and credible in that it does no more than recognise the *de facto* role of contracting. The precise manner in which contracting may be reflected in specific accounting standards is, however, beyond the scope of this paper but some very tentative suggestions may be appropriate.

It has been argued that one aspect of the problem relates to directors. Increased disclosure of accounting policies could go some way towards highlighting the impact of discretionary adjustments by directors, but this is only one aspect of the issue. In order for users to observe the impact of accounting measures upon ABCs, it is also necessary for them to be able to observe the contract terms which are derived from published accounting information. The Cadbury Report went some way towards increased disclosure of ABCs in advocating the publication of the basis of calculation for directors' emoluments. Unfortunately, the report restricted itself to this one contract whereas it could have gone much further by recognising the principle of contracting, and could therefore have proposed similar disclosure for all material ABCs. In this way, the consequences of the accounting policy decisions of directors would at least be more observable to other stakeholders.

A further suggestion might also be to require the filing of all material lending contracts in the same way that annual accounts are filed. Such an approach would not only publish ABCs but also disclose where directors write, or re-write, this type of contract to exclude accounting numbers and therefore circumvent the disclosure requirements advocated above which relate only to ABCs. Of course, such a proposal is only one specific suggestion; the implications of contracting are wide ranging and there is a need for more research. However, even if the ASB were to recognise contracting as an issue, this might be a step forward in opening up the debate.

[21]See Arnold *et al.* (1990).

Conclusion

This paper has argued that the contracting role for financial reporting has a well established academic pedigree. Despite this, at a policy making level, in relation to both financial reporting and corporate governance, the issue of contracts has scarcely been recognised.

The failure to recognise contracting in general, and ABCs in particular, at a policy making level is likely to have a number of consequences for both financial reporting and the process of corporate accountability. Specifically, financial reporting is likely to develop as a less appropriate measure for contracting purposes than might otherwise be the case. Additionally, the current rapid changes in accounting regulation appear to be proceeding without regard for ABCs already written. It has been argued that if these factors are not at least considered, alongside other roles for financial reporting, shifts in wealth, power and risk will occur between stakeholders and the use of contracts as part of the overall mechanism of corporate governance may not become as fully developed as could have been the case had their role been more explicitly recognised.

Viewing the accounting standard setting process within a cost-benefit framework it can be argued that by referring merely to compliance costs a narrow view has been taken by the ASB. A wider view would also recognise and consider the contracting costs associated with new regulations. Similarly, the contracting benefits of new regulations could be considered alongside the informational benefits in a broader cost-benefit exercise than the ASB currently appears to undertake.

Even if the ASB continues not to recognise contracting, the issue seems likely to remain the subject of academic analysis and to be a matter of concern in practice. As such, the silence of the ASB with regard to contracting could be regarded as inappropriate.[22] At the very least, it could provide a statement of its views on the subject, explaining why it has not seen fit to incorporate contracting as one of its objectives. Such a statement would go some way towards opening up the debate at the policy-making level and narrowing the gap between regulatory policy and academic literature.

[22]The observation by Zeff (1978, p. 63) with regard to the need for a regulatory board to '...study—and be seen to study—the possible adverse economic and social consequences of its proposed actions...' is worth recalling.

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SPECIAL INTEREST AREA CORPORATE GOVERNANCE

The Research Board of the Institute of Chartered Accountants in England and Wales wishes to encourage high quality research into aspects of corporate governance. In furtherance of this aim, it has formed a special interest group which has identified specific areas in which it would welcome proposals for projects.

The areas of specific interest identified are:

1. Modus operandi of the Board of a company with references to the roles of chairman, chief executive and non-executives.
2. Non-executives and independence.
3. The role of institutional shareholders in corporate governance.
4. Remuneration packages and issues in executive pay.

Within these areas, research could involve literature reviews, quantitative approaches, case studies or a combination of all three.

There are several ways in which projects can be structured. One theme the group has identified is the topic of 'incentives', i.e. the way in which individuals and groups are encouraged to act in certain ways. Another theme may be the effect of the Cadbury Committee's proposals on corporate policy as to whether the proposals are changing the reality or merely the superficial appearance of corporate policy.

The Research Board plans to present a report on the research which it has sponsored to the successor to the Cadbury Committee in Spring 1995. This report should help the successor Committee to consider if further initiatives are necessary or desirable.

Researchers interested in applying for sponsorship should submit a one page outline to the Research Board as soon as possible. Proposals need to demonstrate feasibility especially in areas where difficulties in access to data or individuals could be expected to occur. If the group considers an application worth pursuing, researchers will need to submit a formal application. Projects which will be of interest to the successor to the Cadbury Committee should be completed by the end of 1994.

Further information can be obtained from:

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